NICE TRY: SHOULD THE TREATY OF NICE BE RATIFIED?

Monitoring European Integration 11

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Monitoring European Integration 11

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Preface

A decade has now passed since we launched our series of *Monitoring European Integration* Reports with the assistance of the German Marshall Fund of the United States. The first ten Reports ranged over a variety of issues. Some focused on issues that were more narrowly economic, such as the optimal strategy for the period leading up to the launch of the euro, and the restructuring of the European financial sector. Other Reports have addressed much wider issues and so have had a much broader focus, going well beyond the traditional remit of economic analysis. These Reports have, of course, been written by economists and have employed the tools of economic analysis, but have addressed issues that many would consider to fall within the domain of political science or international relations.

In this respect, the Reports have reflected a shift in economic research itself, which has over the past two decades devoted growing attention to the analysis of 'political economy' questions. Political economy is also an important theme of the Centre's research agenda. The first EU-funded Training and Mobility of Researchers network with which CEPR was associated, for example, brought together political scientists and economists. The network, which began work in 1996, focuses on the 'Economic Analysis of Political Institutions: Coalition Building and Constitutional Design'. We followed this up last year when we organized, jointly with Toulouse, a CEPR/IDEI Conference on 'The Political Economy of Economic Policy'. The Conference was organized around the theme of 'institutions of restraint', i.e. institutions that limit and shape governmental action at sub-national, national and international levels.

Research in this field is not only a highly exciting intellectual endeavour but also an extremely practical tool, capable of guiding policy-makers. These discussions should be, but too seldom are, based on analysis that is rigorous, yet presented in a manner accessible to public and private sector decision-makers. *Monitoring European Integration* aims to meet this objective, by providing an annual assessment of the progress of, and obstacles encountered by, economic integration in Europe. A rotating panel of CEPR Research Fellows meets periodically to select key issues, analyse them in detail, and highlight the policy implications of the analysis. The output of the panel's work is a short annual Report, for which they take joint responsibility.

The eleventh Report – like the fourth and sixth Reports – falls very much within the tradition of 'broad focus' Reports. The fourth Report, for example, brought together a distinguished team of European economists to provide the first sustained and detailed analysis of the economics of subsidiarity. The authors of this Report, 'Making Sense of Subsidiarity: How Much Centralization for Europe?' argued that adherence to the principle of subsidiarity would require major reforms to European Union (EU) spending priorities. The Report thus brought an important but little understood policy issue to the attention of a wide audience both within Europe.

Published just before the 1996 Intergovernmental Conference, the sixth Report in the series, 'Flexible Integration: Towards a More Effective and Democratic

Europe', argued for significant economic, political and legal reforms of the EU. 'Flexible Integration' is a model of reform designed to overcome the stalemate between federalists and anti-federalists. It introduces more flexibility to accommodate the heterogeneous interests in Europe without risking the gains achieved through past integration. Flexible integration combines firm commitment by all members to a common supranational common base – including a well-defined set of competences related to the Single Market – with optional integration in other areas through 'open partnerships'. The Report analysed an important policy issue from an entirely new perspective. Although published in 1996, the Report has continued to have an important impact on policy discussions in the EU.

This Report (the eleventh in the series) examines the agreements reached at the Nice summit. The Treaty of Nice aims to remove the obstacles to Eastern enlargement imposed by the Amsterdam Treaty, and to adopt reforms that ensure EU institutions will function effectively after enlargement (which will almost double the membership of the EU). The Report argues that Nice meets the first objective – the obstacles to enlargement have indeed been removed. Nice fails almost completely to achieve the second goal, however, of ensuring that EU institutions will function effectively after enlargement.

The Report does make a persuasive case that Nice failed in its attempt to address each of the key issues left open after Amsterdam: the size and composition of the Commission, the extension of qualified majority voting in the Council of Ministers, and reform of Council voting rules. On the Commission, the Report argues that Nice adopted only a makeshift reform and postponed all the tough decisions. On the extension of qualified majority voting, Nice made few changes in the sensitive areas. On Council decision-making, the Report's careful analysis suggests that Nice has made things worse. The new, highly complex system will not only reduce decision-making efficiency in the Council, but also lessens the system's legitimacy, by shifting power to the larger nations. In this sense, it might seem as if the EU would be better off without the Nice reforms.

The Report is very critical of the Nice agreements, yet concludes that the Treaty should be ratified. The argument in favour of ratification is surprising, but simple and persuasive: 'Institutional reforms can wait; Eastern enlargement should not.' Failure to ratify the Treaty would simply return the EU to the situation created by the Amsterdam Treaty, which made reform a precondition for enlargement. Without the Nice reforms, the enlargement process would simply grind to a halt. The Report argues that enlargement should proceed, and that there will be an opportunity to repair the flaws in the Treaty.

If the Treaty is indeed ratified, then the EU must move quickly to address these flaws. Here the Report sets out a detailed plan for 'emergency repairs'. Some reforms, such as those involving the voting procedures in the ECB, can take place very quickly, without further treaty revisions. The Report sets out three ways in which the efficiency of the ECB's decision-making can be preserved. The other repairs require treaty revisions, but these can also take place relatively quickly, in the context of the 2004 Intergovernmental Conference. This IGC is intended to address issues such as subsidiarity and governance, but the Report argues that it should at the very least repair the flaws in the new voting procedures in the Council of Ministers. The Report suggests a set of changes in the criteria for majorities, changes which are straightforward but

which would allow the Council of Ministers to act effectively despite the growth in numbers which enlargement entails.

The authors and CEPR are grateful to Lisa Moss, as well as other staff at CEPR whose patience and professionalism have been most helpful in the production of this Report.

The opinions expressed in this Report are those of the authors alone, and not of the institutions to which they are affiliated nor of CEPR, which takes no institutional policy positions. The Centre is extremely pleased, however, to offer to an outstanding group of economists this forum for the analysis of an issue of vital importance to Europe.

Stephen Yeo
18 May 2001

Executive Summary

The Nice summit had two goals:

- to remove obstacles to Eastern enlargement imposed by the Amsterdam Treaty; and
- to adopt reforms that ensure EU institutions will operate efficiently and legitimately after membership nearly doubles.

The summit results fully met the first. They failed almost completely on the second.

What Nice failed to do

The Amsterdam Treaty left open three issues and explicitly required that they be settled before enlargement: the size and composition of the Commission; extension of qualified majority voting (QMV) in the EU's Council of Ministers; and reform of Council voting rules. This report documents that Nice failed:

- on **Commission reform**. Nice adopted a makeshift, temporary reform – temporary since it only applies from 2005 to the date when the 27th member has joined; makeshift since the long-term solution was not set. As in Amsterdam, the tough decisions were postponed.
- on **extension of qualified majority voting**. Nice was basically a house-cleaning exercise with little or no change in sensitive areas.
- on **Council decision-making reform**. Nice actually made things worse as we explain at length in Chapter 3. With little more than hurried, late-night staff work and their political instincts to guide them, EU leaders adopted a massively complex system.
  - Using quantitative tools from voting game theory, we find that far from maintaining efficiency, the Nice voting reforms will *lower* the enlarged EU's ability to act, i.e. the decision-making efficiency in the EU27 would have been higher with no reform at all.
  - Nice also lessens the system's legitimacy. It shifted power to large nations to such an extent that the historical balance between the EU as a union-of-states and a union-of-people has been altered.
- on solving the **ECB's 'numbers problem'**. Nice was supposed to implement all institutional reforms necessary to prepare for enlargement. It ignored the simple fact that enlargement faces the ECB's Governing Council with the same 'numbers problem' that got Commission reform on the Nice agenda. Enlarging an unreformed European Central Bank (ECB) to include 5 or 12 new members would turn this critical policy-making body into a big, unwieldy group that would have trouble taking difficult decisions at the right time. As part of this, we argue – based on a scrutiny of the EMU accession process which takes account of past exceptions – that EMU enlargement will come soon after EU enlargement, perhaps as early as mid-2005 if the newcomers join the Union in January 2004. See Chapter 6 for details.

– The Treaty, however, does recognize the problem. It invited the ECB and Commission to propose solutions, and instituted an 'enabling clause' that allows limited ECB reform in what amounts to a single-issue Inter-Governmental Conference (IGC).

● on **locking-in a long-term enlargement procedure**. Enlargement is a process, not an event, and there is a strong possibility that the first enlargement wave may seriously delay subsequent waves and hinder the reform momentum in applicant nations not yet in. To redress this, the EU should commit to a series of Maastricht-style 'entrance exam' dates that locked in dates for evaluating which nations are ready to join (similar to the EMU evaluation dates dictated by Maastricht). This is not necessarily a matter for Treaty changes, but Nice would have been the ideal opportunity for a political commitment to dates.

Institutional balance of power

The Nice Treaty will significantly alter the way the EU functions. Due to curtailed Council decision-making efficiency, the hereto standard method of European integration – which relies on legislation and thus the Council's ability to act – will, we argue, be massively slowed. Further integration, if it occurs, is likely to rely more on member states' initiatives, perhaps channelled into new enhanced cooperation arrangements. Thus to the extent that the European Parliament and Commission derive their power from influencing legislation, Nice reduces their power. As a body, the Council's power will also be diminished. The winners will be those members who wish to proceed with deeper or broader integration in the form of enhanced cooperation or outside the EU framework altogether. The Commission has a crucial role in enhanced cooperation arrangements (ECAs), so if ECAs become more common, the Commission's influence may expand along this dimension; this may have been the Commission's biggest victory at Nice.

Should the Treaty be ratified?

This is not a positive assessment of the Treaty, so the question is: should the Nice Treaty be allowed to become law? Our answer is simple.

Yes.

Institutional reforms can wait; Eastern enlargement should not. The European ideal was born in the ashes of devastation caused by intolerance and destructive nationalism. The East-West division of Europe is the last remaining element of this pre-1945 world and only Eastern enlargement can remove it. Enlargement will fulfil the aspirations of 100 million Europeans who chose freedom, democracy and markets; it will ensure political and economic stability in Europe. Enlargement, quite simply, is a historical imperative. Council voting weights will be a historical footnote.

Moreover, killing the Treaty would recreate the situation that led to the Nice mess in the first place. The Amsterdam Treaty made EU reform a precondition

for enlargement. This sequencing was at least part of the reason why Nice became the longest IGC in history and still did not manage to achieve its goals. When reform is a precondition for enlargement, interests that are lukewarm to enlargement are granted important leverage. Had enlargement instead been locked in first, such 'hostage taking' would have been less effective.

Now, if the Nice Treaty is ratified, the sequencing will be reversed. When EU reform is next considered, enlargement will have happened or be imminent; no one will face the choice between accepting damaging reforms and delaying enlargement. There is even hope that the new members will have some say and this should make the agreed reforms more sustainable.

Fortunately, Nice also created a window of opportunity for reform – the IGC to be held in 2004. Although IGC 2004 is aimed at unrelated issues (subsidiarity and governance, Charter of Fundamental Rights, etc.), its agenda could be expanded to include 'emergency repairs'.

Can the damage be fixed? ECB reform, and 'emergency repairs' to the voting system

- The ECB's numbers problems should be fixed soon, and the Treaty's 'enabling clause' should make it possible well before IGC 2004.
- There are three practical solutions: (1) rotation of voting rights among central bank governors; (2) representations of groups of nations by a single central bank governor, or (3) delegation to a group of independent experts – like the Executive Board, possibly extended to include outside experts, as is the case in other central banks – with the governors participating in the debate but not in the vote.
- We recommend the third option; it would yield a manageable-sized voting body whose composition was stable. Moreover, and importantly, unlike the other two options, it does not encourage the public to view monetary policy from a national perspective.
- The ECB is likely to deadlock over what solution to propose and this hands a unique opportunity to the Commission. The Commission should exploit it by tabling the only rational proposal – delegation.

And, presuming EU leaders do want a Council of Ministers that can act, the IGC 2004 should:

- Re-adjust Council of Ministers' voting procedures. The Nice summit instituted a new, complex Council voting procedure (from 2005) that involves a triple majority. The damage done to EU27 efficiency could be mended with 'emergency repairs' that lowered two of the three majority criteria (see Chapter 8 for details). Specifically, the next Treaty should:
  - Lower the 74% vote threshold to two-thirds. This would restore the Council's ability to act. It would, however, further reduce the power of small and medium size members (since with the lower threshold, the population criteria matters more). This side-effect could be avoided by:
  - Lowering the population threshold to one-half.

Did they mean it?

All this presumes that EU leaders meant what they said in Cologne, that the goal of Nice summit was to 'ensure that the European Union's institutions can continue to work efficiently after enlargement'. Yet the question still remains. Did EU leaders know what they were doing at 4.30 a.m. on Monday 11 December?

In one view, EU leaders did not realize the strong inefficiency consequences of their actions; the outcome was a collection of unintended consequences stemming from ill prepared late-night debates. This is not entirely implausible. The Council voting system that was eventually adopted was never discussed during the IGC, and the reforms do not look so bad from the perspective of the EU15 – the Council that these eminently practical leaders know well. Yet in the EU27 – a Council that might seem distant and abstract to leaders who are unlikely to hold office for even five more years – the efficiency consequences are dramatic.

In another view, the EU leaders got what they bargained for – a crippled legislative process that strips the Commission and Parliament of their agenda-setting power and the old Community Approach of its viability. In this worldview, future European integration will be guided by intergovernmental initiatives with the large members inevitably playing a role more commensurate with their economic and demographic importance. This view is also not implausible. For some members, integration has reached the level perceived as legitimate by the voters. In these countries the leaders may be quite satisfied with an EU where the key institutions are seriously constrained and decisions are mainly taken directly between governments. There may also be those who never accepted the notion that a dozen or more small nations – nations whose populations are smaller than a big city – should have a major say in how to run a Europe that produces a third of world output and boasts almost 500 million citizens. Holders of this view may also be satisfied with Nice.

The question of which view is correct matters greatly for what comes next.

- If it was an oversight – at least in the eyes of most members – then there is still time for some emergency repairs and IGC 2004 provides a perfect opportunity.
- If it was wilful, it may take a high-profile decision-making crisis or two in the enlarged EU (e.g. a deadlock in the 2006 negotiations on the next financial perspective that threatens to leave the EU without a budget, or a deadlock over CAP and Structural Funds reform) to mobilize the resolve necessary to reform the Nice reforms.

Either way, the Treaty of Nice was no better than a 'nice try'. Although it failed to adjust EU decision-making to the realities of an EU with 27+ members, it did open the door to enlargement. It should be ratified and then repaired at the IGC 2004.

1 **Introduction**

The Treaty of Nice was long in the making, but the process is not finished.[1]

Each EU member must ratify the Treaty – by a vote of its national Parliament or by a popular referendum, according to national rules. The European Parliament will also vote on it. The outcome of this vote will be important, even though the European Parliament cannot formally veto the Treaty.

The Treaty must therefore pass 16 more tests.

This report is an assessment of the Treaty of Nice, and is aimed at contributing to these evaluations. The report is highly critical of the Treaty, but recommends that it be ratified since otherwise eastern enlargement will be delayed. We also recommend two 'emergency repairs' that would go a long way to redressing some of the Treaty's shortcomings.

Logic of the report's structure

The report is in three parts.

- **Part 1** evaluates the reforms in the Treaty. This evaluation is divided into four chapters.
  - Chapter 2 presents the Treaty's main elements.
  - Chapter 3 contains the 'meat' of our report – an evaluation of the Treaty's impact on EU decision-making. The chapter argues that enlargement teamed with the Treaty reforms will seriously impair the Council of Ministers' ability to act – what is called 'efficiency' in most IGC documents. *Efficiency in the EU27 would have been higher with no reform at all*. The chapter also shows that the reforms shifted power from small members to large members, and argues that the magnitude of this shift threatens the balance between the EU as a union-of-states and as a union-of-people.
  - Chapter 4 considers 'enhanced cooperation'. Although the Amsterdam Treaty established the basic mechanism, the Nice Treaty makes it much easier to use. Given that the Council of Ministers' decision-making will be enormously difficult, enhanced cooperation could become an important engine of future European integration.

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1 The process opened with the Inter-Governmental Conference (IGC) on St Valentine's Day 2000 and culminated on 11 December 2000 with a political agreement among EU leaders at their Nice summit meeting, which – after two months of post-summit negotiations – produced the legal text for signature on 26 February 2001.

–   Chapter 5 studies the Treaty's impact on the balance of power among the four main institutions (Parliament, Council, Commission and Court). It argues that the sharp drop in the Council's ability to act will choke off the flow of EU legislation and thereby *de facto* reduce the powers that the Parliament and Commission derive from shaping EU legislation.

●   **Part 2** considers the 'Nice leftovers', namely the items that should have been in the Treaty but were not. We focus on two.

–   Chapter 6 argues that the European Central Bank (ECB) needs reform. Enlargement will face the Bank's decision-making mechanism with the same 'numbers problem' that is facing the Commission; quite simply there will be too many decision-makers at the table and this will hinder the ECB from taking hard decisions at the right moment.

In addition to characterizing the problem, the chapter evaluates possible solutions. Any solution must reduce the number of central bank governors who vote via a system of (1) rotation, (2) representation or (3) delegation of monetary policy to an independent body. The chapter argues that only one solution makes sense – delegation of interest-rate setting powers to the ECB's Executive Board.

–   Chapter 7 points out that since enlargement will happen in waves (even if the 12 applicants get in a 'big bang', there are more countries in-line), the first enlargement may seriously delay subsequent enlargements and this could discourage reform in the applicants still in-line. To avoid this, the Treaty of Nice should have set down a series of 'exam dates', which – much like the Maastricht Treaty date for evaluation of EMU eligibility – would establish a clear timetable for when nations will be judged on whether they are ready for membership. This is not necessarily a matter for Treaty changes, but as with monetary union, etching dates into the Treaties is the best form of political commitment.

●   **Part 3** gives the report's answer to the question posed in its title: 'Should the Treaty be ratified?' That answer is: '*Yes, faute de mieux*'. It also recommends a pair of 'emergency repairs' – seemingly small changes that would allow the EU to operate efficiently even after doubling its membership. These are (1) a reduction in the Council's majority threshold on votes from 74% to two-thirds, and (2) a reduction of its threshold on population from 62% to 50%. The first is shown to be essential for efficiency, the second for equity.

This report is related to an earlier study undertaken by the same authors, namely Baldwin et al. (2000).[2] That study, which was completed before the Nice Treaty was signed, evaluated the five voting-reform proposals that IGC negotiators were considering just before the Nice summit (according to publicly available documents). We found that only the so-called double simple majority (a qualified majority in the Council would require votes from nations that represented half the EU population and half the EU members) would maintain decision-making efficiency. The actual Council voting reform adopted at Nice was not among the five proposals. In the current report, we use most of the same methods of evaluation, but apply them to the actual reforms agreed in Nice.

2   This and all other CEPR publications are available on-line at www.cepr.org.

The earlier report also argues at great length that ECB reform should have been discussed at Nice. The current report repeats much of that analysis but adds a new, more rigorous analysis of the *status quo* bias stemming from enlargement. More importantly, the current report considers the various reform options in much greater depth and makes a specific proposal for how to solve the Bank's 'numbers problem'.

Part 1
Evaluation of the Nice Treaty

2 The Treaty of Nice: Goals and Achievements

Everyone knew it.

Enlargement required reform of EU institutions; institutions designed for six and groaning under the weight of 15 would collapse under 27 members. As the June 2000 Presidency Report on the Inter-Governmental Conference (IGC) stated:

> Faced with the challenge of virtually doubling membership of the Union, it seems indispensable that the Conference adopt at an early date reforms which will, in the future, ensure *the efficiency of the institutions of the Union while preserving its legitimacy as a Union of States and peoples* and the fundamental balances and originality of an enterprise that has shown its worth over fifty years. (Emphasis added)

EU leaders all agreed.[1] Thus the prime goal of the Nice meeting was to adopt reforms that would maintain the EU's democratic legitimacy and its ability to act – what was referred to as 'efficiency' in most official documents. To accomplish this, the IGC was to focus on the so-called Amsterdam leftovers, that is:

- weighting of votes in the Council;
- extension of the use of majority voting in the Council to areas currently subject to unanimity;
- size and composition of the Commission.

All three aimed to bolster post-enlargement efficiency and equity of EU decision-making. The Feira summit added a fourth agenda item, namely:

- closer cooperation, which subsequently came to be called enhanced cooperation.

This chapter presents the Nice reforms concerning these four main agenda items. For additional details see the Treaty of Nice site, www.europa.eu.int/comm/nice_treaty/index_en.htm. We start with reform of the Council of Minister's qualified majority system.

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1 For example, the unanimously agreed Conclusions of the June 1999 Cologne summit meeting of EU leaders announced that 'In order *to ensure that the European Union's institutions can continue to work efficiently after enlargement*, the European Council confirms its intention of convening a Conference of the Representatives of the Governments of the Member States early in 2000 to resolve the institutional issues left open in Amsterdam that need to be settled before enlargement' (Paragraph 52, emphasis added). Later the goal of legitimacy was added. For example just six months before the Nice meeting, the Feira summit conclusions stated: 'The Presidency's report demonstrates the significant headway which has been achieved by the Conference *in considering Treaty changes which will ensure that the Union continues to have properly functioning, efficient and legitimate institutions after enlargement*' (emphasis added).

<u>2.1</u> Council voting reforms

The Council of Ministers plays a crucial role in the EU's legislative procedures and the Treaty of Nice significantly changes how the Council functions. Understanding these changes, however, requires some background on how the Council operates now.

2.1.1 The current rules

The Council of Ministers is made up of a minister from each member nation – agriculture ministers for agricultural matters, treasury ministers for tax issues, etc. For very important issues, such as Treaty changes, enlargement and fiscal questions, these ministers make decisions on the basis of unanimity, but for most decisions (about 80% of Council business including all Single Market issues) they decide on the basis of a complex system called 'qualified majority voting', or QMV in euro-ese.

Under QMV each member state's minister casts a certain number of votes with more populous members having more votes (e.g. France has 10 votes while Denmark has only 3). Right now, the total number of votes is 87 and the threshold for a winning majority, called a 'qualified majority', is 62. This means that about 71% of all votes are required to adopt a proposal. The implications of this system are complex.

Since bigger members have more votes, 71% of the votes does not mean 71% of members. For instance, three large members voting 'no' can block adoption even if the other 12 vote 'yes'; and since small nations get far more votes than strict population-proportionality would suggest, 71% of the votes does not mean 71% of the EU population. The 71% threshold can be reached, for example, by a coalition of just eight members representing 58% of the EU population.[2]

2.1.2 What they did in Nice

The Nice Treaty reforms – which take effect only in 2005 – change qualified majority voting in two main ways.

- *The Nice Treaty makes the qualified majority system more complicated.*
  The Treaty keeps the basic shape of the current qualified majority voting framework, but adds two new criteria that a winning majority must meet. Thus under the Nice reforms (which take effect in 2005), a proposition passes only when the coalition of yes-voters meets *three* criteria concerning:

  1. votes,
  2. members, and
  3. population.

  Specifically, a winning coalition must have at least 71% of the Council votes (rising to 74% when all 12 candidate countries are members); and must represent at least 50% of the EU member states, and at least 62% of the EU population.

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2 There are further nuances in procedure (see http://www.europarl.eu.int/factsheets/default_en.htm) and deeper subtleties in its operation (see Laruelle and Widgrén, 1998).

- *The Nice Treaty changes the number of votes assigned to members, favouring big nations.* As can be seen from Figure 2.1, Nice gave more votes to all incumbents, but it gave proportionally more votes to large nations. Nevertheless, small nations are still over-represented compared to their populations – note that the population line falls faster than both the post-Nice and pre-Nice number-of-vote lines (see also Box 2.1).

The Nice Treaty also addressed the range of issues to be decided by QMV. We turn to this next.

BOX 2.1 The implicit Nice reweighting formula

Straightforward statistical techniques allow us to deduce the implicit formula that was used in allocation of votes in the Nice summit. Using these techniques, the best fit we found was one that multiplied a member's current votes by 2.4, added 4.7 votes for a lost Commissioner and 2.9 extra votes for Spain. This formula explains 99.4% of the actual vote allocation, but it slightly under predicts the Netherlands' extra vote and it slightly over predicts the votes Luxembourg got.

Figure 2.1 Nice's reweighting of Council votes in favour of large nations
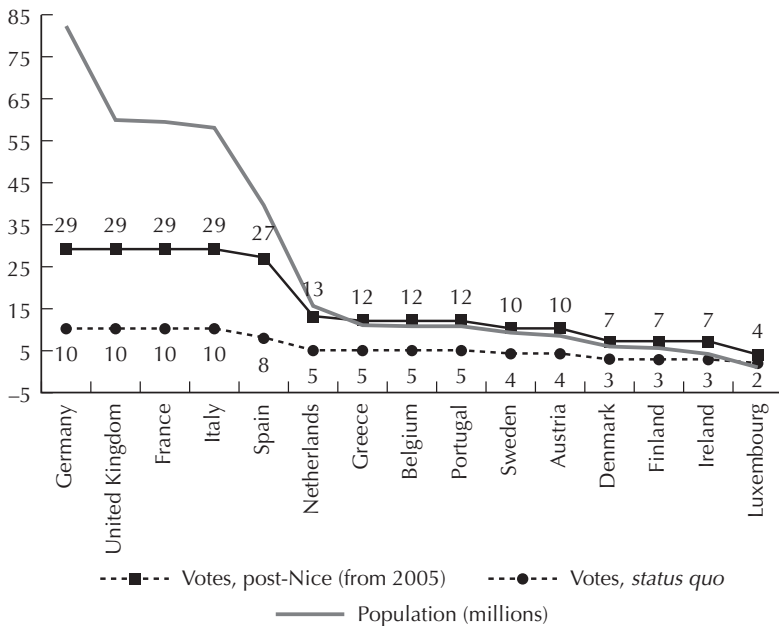
Notes
Members are arranged from largest to smallest populations and the lines show their current Council votes (circles) as well as the new numbers (squares) and populations in millions.

This shows that the Nice reform gave more Council votes to all EU15 members, but many more to the big five. Luxembourg's votes rose by 100%, Netherlands' by 160%, and France's by 190%. Spain did remarkably well, increasing its votes by 238%.

2.2 Extension of qualified majority voting (QMV)

Getting 15 diverse nations to agree on important issues can take an Olympian effort. Adding in another 12 members – each with a veto – raises the danger of paralysis. In response, IGC 2000 was supposed to reduce the number of issues subject to unanimity.

2.2.1 What they did in Nice

Coming into Nice, 75 Treaty provisions were subject to unanimous voting, with most of these in the areas of institutional balance, the common foreign and security policy, police and judicial cooperation, taxation, and social security (Yataganas, 2001). All member states wanted to remove unanimity on 25 of these, but the Commission as well as the Portuguese and the French Presidencies pushed for extending QMV to the rest (Yataganas, 2001). The final negotiations concentrated on the five sensitive areas where QMV would be important to avoid deadlock in an enlarged EU: taxation, social policy, cohesion policy, asylum and migration policy, and common commercial policy.

Negotiation quickly revealed each of these to be a deal-breaker to one member or another, so in the end the veto was removed only for 27 provisions. The veto was kept for the coordination of social security systems, all treaty provisions relating to taxation, and on measures to combat fraud against public finances. Unanimity was also retained for migration and asylum. After accepting exemptions for culture and audiovisual services, QMV was extended to broader areas of trade in services including international agreements in the area of trade in services and the commercial aspects of intellectual property. Cohesion policy was shifted to QMV, but only after 'financial perspective' (i.e. the multi-year budget plan) for 2007 has been decided by unanimity. With enlargement likely in 2004 or 2005, this means that the first wave of newcomers will have a veto over the allocation of cohesion spending. This could create problems since it may prove politically difficult for the premier of, say, Poland to support a package that grants fewer euros per head to Poles than it does to the comparatively rich Spanish and Irish.

Importantly, qualified majority will be the rule for appointing Commissioners, including the Commission President. The same applies to members of the Court of Auditors and several EU posts. See Box 2.2 for more details.

BOX 2.2 Details of QMV extension

The results for the five key areas identified by the Commission are:

- **Taxation** (Articles 93, 94 and 175 of the EC Treaty): No progress. Maintenance of unanimity for all measures.

(continued)

(Box 2.2 continued)

- **Social policy** (Articles 42 and 137 of the EC Treaty): No progress. However, the Council, acting in unanimity, can make the co-decision procedure applicable to those areas of social policy which are currently still subject to the rule of unanimity. This 'bridge' cannot, however, be used for social security.
- **Cohesion policy** (Article 161 of the EC Treaty): No progress until 2007. There will be a switch to qualified majority voting, but only after adoption of the multi-annual financial perspectives applicable as from 1 January 2007.
- **Policy on asylum and immigration** (Articles 62 and 63 of the EC Treaty): Little and delayed progress. Application of QMV is postponed to 2004 and then will not concern the central elements of these policies, e.g. the 'sharing of the burden' (Article 63(2)(b) or the conditions for entry and residence of nationals from third countries (Article 63(3)a).
- **Common commercial policy** (Article 133 of the EC Treaty): Some progress. This will include the negotiation and conclusion of international agreements in the area of trade in services and the commercial aspects of intellectual property. These agreements are concluded by qualified majority, except when the agreement includes provisions for which unanimity is required for the adoption of internal rules or when the agreement concerns an area on which the Community has not yet exercised its responsibilities. In addition, the agreements concerning the harmonization of cultural and audiovisual services, education services, social services and health services are excluded.

Note: This box is based closely on 'Summary of the Treaty of Nice', *Memorandum to the Members of the Commission*, 18 January 2001, Secretary-General of the Commission, SEC(20001) 99.

In a related change, most of the legislative measures that the Treaty of Nice moves to QMV will now be subject to Parliamentarian approval under the co-decision procedure.

2.2.2 Appraisal

The President of the European Commission, Romano Prodi, noted that the extension of QMV to 27 provisions was quantitatively but not qualitatively important. In his 12 December 2000 speech to the European Parliament, he characterized this aspect of the Treaty as disappointing:

> Little or no progress was made on cohesion, tax regulation and social legislation, all sensitive areas in which the Conference came up against the intransigence of some member states. This is something which disappoints me, not just because of the short-term consequences, but because the attitude behind it shows a lack of openness and understanding.

We turn next to reform of the Commission.

2.3 The Commission

Going into Nice, EU leaders all recognized that the current system of allocating Commissioners (one per member plus an extra for big nations) would result in a bloated – and ineffective – Commission of 30+ members. The Nice Treaty's solution to this problem is half-hearted.

The Nice agreement limits each member to one Commissioner from 1 January 2005. When the 27th member joins, the Council is supposed to decide – by unanimity – that some members should be without a Commissioner. The tough questions – how many members go without a Commissioner and how the rotation works – are postponed until the 27th member joins. The only point agreed was that there should be no two-tier rotations (e.g. big nations having a Commissioner more often).

The Treaty also boosted the powers of the Commission President as a way of improving the effectiveness of a large Commission. The President can allocate and reallocate responsibilities and can demand a Commissioner's resignation, subject to the Commission's approval.

The next section concerns the EU's approach to subgroups of members pursuing deeper integration within the EU's institutional framework.

2.4 Enhanced cooperation

Subgroups of EU members have long engaged in closer intergovernmental cooperation (Schengen Agreement, etc.); these practices were embraced and disciplined by the Amsterdam Treaty's provisions on 'closer cooperation'. Conditions on starting new closer cooperations were strict, so although they brought the existing Schengen Agreement under the EU 'tent', no new closer cooperation has been established under the Amsterdam rules.

Most Nice Treaty provisions on enhanced cooperation arrangements (ECAs) are an overhaul of provisions already in the Amsterdam Treaty. This was useful since previously it was difficult to have an overview of closer cooperation (the relevant articles were sprinkled around the Treaties).[3] This does make it difficult to understand what Nice added, however, in Box 2.3 we present the Amsterdam Treaty provisions. The Nice Treaty's main innovations are:

- Members no longer have a veto over the creation of enhanced cooperation arrangements (ECAs) in first-pillar (economic) or third-pillar (justice and home affairs) areas.[4]
- The minimum number of initial members is fixed at eight.

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3 The provisional version of the Nice Treaty is especially helpful on this score since the French Presidency redrafted the Amsterdam Treaty provisions into 16 clauses (A–P) divided into four categories: the general principles governing the whole mechanism (A–F); clauses applicable in the context of the first pillar (G and H); clauses applicable under the third pillar (clauses N–P); and clauses which may be applicable under the second pillar (clauses I–M). The final Treaty separates the clauses into articles to be spliced onto various branches of the Treaties.

4 One method of remembering the pillar numbering is to recall that in the EU, economics comes first, justice comes last and security is in between.

BOX 2.3　Closer cooperation in the Amsterdam Treaty

EU members have long pursued deeper or broader integration outside the EU and several Amsterdam Treaty provisions were aimed to bring such integration inside the EU structure (specifically, Treaty on the European Union (TEU, Title VII) and the Treaty Establishing the European Community (TEC, Article 11)). However, to date no members have availed themselves of this possibility.

- **Conditions.** Under the Amsterdam Treaty, a closer cooperation (CC) had to meet a number of conditions. It has to aim to further the objectives of the EU and protect and serve its interests; respect the principles of the Treaties and the single institutional framework of the EU; be used only as a last resort; concern at least a majority of members; not affect the *acquis* or the measures adopted under the other provisions of the Treaties; not affect the competences, rights, obligations and interests of those members who do not participate; and be open to all members, provided that they comply with the decisions taken within that framework.
- **Activation.** Arrangements under the first pillar, which had to be proposed by the Commission, were authorized by the Council, on a QMV basis, after consulting the Parliament. This gave the Commission a *de facto* veto. Importantly, any member state could – for 'important reasons of national policy' – veto an arrangement by requiring unanimous approval by the European Council. Third-pillar arrangements were authorized by the Council, acting by QMV after obtaining the Commission's opinion and informing the Parliament, but again all members had a *de facto* veto. The notion of 'constructive abstention' in TEU Article 23 permitted *de facto* CCs in the second pillar.
  The spectre of new members using these vetos to extract 'sweeteners' is probably what led the EU15 members to agree to switch to QMV on first and third-pillar CCs (now called enhanced cooperations).
- **Operation.** Rules for the operation of CCs were also agreed at Amsterdam. When deciding upon rules and acts necessary to implement and operate a CC, all EU members participate in the discussion but only active CC members can vote. The decision-rule (QMV, unanimity, co-decision or consultation) is governed by the relevant provisions of the Treaty area it falls under. Except for the Council, EU institutions involved in the decision-making process, e.g. the European Parliament and the Commission, do so in their entirety without regard to which members are active in the relevant CC.
- **Enlargement.** The basic principle is that any EU member could join a CC at any time, provided it was willing and able to comply with existing decisions. For first-pillar CCs, the Commission decides both who gets in and also any specific arrangements it considers necessary. For third-pillar CCs, the Commission gives its opinion but it is the Council which decides; with entrance granted unless a qualified majority opposes.
- **Financing.** Except for administrative costs, CC-related costs are shared among active CC members.

Note: This box draws heavily on the Commission's web publication, 'The Amsterdam Treaty: a Comprehensive Guide'. This is available as of April 2001 at:
http://europa.eu.int/ scadplus/leg/en/s50000.htm

- Enhanced cooperation is now allowed in second-pillar (security) areas – except in matters with defence implications – but starting such an ECA is subject to veto by any member.

All three of these innovations make it easier to start an ECA; whereas under the Amsterdam rules such arrangements had to contain at least half the EU members, allowed any member to veto their start (including those who choose not to participate), and ruled out second-pillars ECAs.

Importantly, the Nice Treaty clarifies that decisions and acts pertaining to ECAs are not part of the *acquis communautaire* and apply directly only in the participating nations.

While these changes may seem unimportant, we shall argue that this is probably the most pro-integration aspect of the Nice Treaty.

<u>2.5</u> Summary

The IGC 2000 agenda contained four main items: Commission reform, extension of QMV, facilitation of enhanced cooperation and reform of Council voting rules. On the first two, the Treaty of Nice did little – the hard decisions on Commission reform were postponed to the distant future and few areas of importance were shifted to QMV. While real progress was made on enhanced cooperation, the big disappointment concerns the rules governing the keystone of EU decision-making – the Council of Ministers. These were reformed but – as we argue at length below – not in a way that boosts the enlarged EU's ability to act.

Evaluating the impact of the Council voting reform is the subject of the next chapter.

3 Impact on EU Decision-making

This chapter argues that the Nice reforms fail to maintain EU decision-making effectiveness and legitimacy in the face of enlargement. Moreover, the reforms will greatly complicate the EU's decision-making procedures and significantly reduce the power of small members, concentrating it instead in the hands of large members.

To make these points, the chapter employs quantitative tools to the greatest extent possible. We start first by studying the impact that the Nice reforms will have on the EU's ability to act after enlargement.[1] The subsequent section considers the Treaty's impact on the distribution of power, identifying the winners and losers from the reforms of the Council of Ministers' voting rules. The implications for democratic legitimacy are then studied before the final section summarises the findings and speculates on how they came about.

3.1 Decision-making efficiency

The EU is not a static concept.

Just maintaining the integrity of the internal market in the face of evolving technology and member state policy requires decisions to be made and policies to be adopted. Deepening and broadening European integration – a goal that all members share to varying extents – also requires a steady stream of legislation. The greatest shortcoming of the Nice Treaty is that it fails to maintain the enlarged EU's ability to act. Indeed, the Nice reforms made matters worse; the EU's ability to act post-enlargement would have been greater with no reform at all. To demonstrate this point, we rely on quantitative measures that gauge how hard it is to pass proposals in the Council of Ministers. Explaining these measures is the first order of business and thus dealt with first, before using these tools to evaluate the Nice reforms looking at the EU15, the EU27 and, looking further in to the future, the EU36. Since the notion of efficiency in decision-making is a strange one ('Is more efficiency always better?'), Appendix 1 proposes a simple analytic framework for thinking about Council–Commission interactions and the optimal level of efficiency.

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1 See Kirman and Widgrén (1995), and Baldwin (1994) for early illustrations of the difficulties that enlargement would entail for EU decision-making.

3.1.1 **Measuring the unmeasurable**

Efficiency is hard to define, but the main problem is one of perspective; nations tend to define efficiency in their own image. Germany, for example, may view the Luxembourg veto of withholding taxes as an example of inefficiency in the decision-making process, while Luxembourg may view its veto as an example of just how well the system works. This difference over details, however, can be overcome by the artifice of the 'veil of ignorance'. That is, by focusing on how difficult it would be to approve a randomly selected issue – random in the sense that no member knows whether it would be for or against the proposition.

This is not the perfect way to gauge whether the Nice reforms met the goal of maintaining decision-making efficiency, but it is the best practical way. To do the perfect job, one would need an extremely detailed knowledge of the unknowable – a list of all decisions that will arise in the Council of Ministers and how every current and future member will vote on them. Admitting that this information is unknowable, it is tempting to evaluate proposals based on speculation about issues and positions. How would the 'Club Med' vote on this issue, and the 'northern fringe' on that issue? As well as being difficult (there are more than 130 million possible coalitions in the EU27), the results of such exercises are arbitrary since reasonable people can differ over the forecasted issues and positions. Our admittedly imperfect solution is to employ a quantitative efficiency measure – a measure that may, at first, sound radical.

A quantitative measure of efficiency: passage probability
The measure – the passage probability – abandons all pretence of detail and embraces instead the 'Law of Large Numbers'. It is, however, the best and really the only way forward. The argument is succinct, but requires some background.

Here is the background. Explaining our measure to an intelligent non-specialist typically elicits an embarrassing combination of mirth and disbelief. Something like what an economist hears when he tries to convince a marketing manager that sales can be very accurately explained only with prices and incomes. 'Yes', the marketer replies, 'pricing points are important, but the really critical factors are motivating the sales force, having a coherent branding strategy, and establishing clear lines of communication with consumers'. Both the economist and marketer are right. Understanding sales of one brand of toothpaste in a particular market requires more than prices and incomes. When aggregating across a few products and markets, however, the simplifying magic of the Law of Large Numbers works wonders. Branding and sales forces become random shocks that wash out of the averages. In short, the economist is right at the aggregate level and the marketer is right at the micro level.

Here is the argument. The aggregate, not the micro, is what reformers should focus on. After all, Charles de Gaulle was elected President in the year current EU decision-making rules took effect, yet these rules have a major impact on EU regulation of e-commerce. Would it have been wise in 1958 to tweak the rules to ensure that the 'Club Med' coalition would not have blocking power on e-commerce decisions? Plainly not. The success of the EU rests on its cumulative, that is to say aggregate, track record. Reform of decision-making rules must, therefore, studiously focus on the aggregate. This turns the necessity of working with the Law of Large Numbers into a virtue.

Efficiency defined: passage probability

The passage probability measures how difficult it would be to approve a randomly selected issue. Here is how it works.

The computer calculates all possible coalitions among member states (there are 32,768 in the EU15) and then determines how many of these are winning coalitions. In a perfect world, we would know how likely each coalition is, but in the absence of this knowledge, we rely on a Hegelian 'veil of ignorance' and assume that for a randomly chosen proposal, all coalitions are equally likely. Under this assumption, the ratio of winning coalitions to total coalitions provides a measure of how likely a randomly chosen issue is to pass; this is the passage probability. In a nutshell, it is the ratio of the number of winning coalitions in the Council to all possible coalitions. Its level is affected by the number of members, the distribution of votes and, above all, by the majority threshold.

Of course, the exact *level* of the passage probability is almost entirely useless since the Commission only proposes things it thinks will pass. Appendix 1 presents the simple framework we use to organize our thinking on the optimal efficiency question, but no one can really say what the optimal passage probability is. We can, however, use it to see how the Nice reforms *changed* the EU's efficiency. This is where the measure's usefulness becomes apparent; the passage probability lets us check whether the EU leaders attained their self-set goal of maintaining the current level of EU decision-making efficiency.[2]

Note that throughout this chapter we focus on the Council of Ministers and qualified majority voting (QMV), ignoring the impact of enlargement on the efficiency of European Parliament decision-making. Box 3.1 explains why. As it turns out, enlargement does not affect the European Parliament's passage probability.

3.1.2 Nice's efficiency impact

Before using this tool to evaluate the Nice reforms, it is useful to 'test' it out on historical EU configurations. The five leftmost bars in Figure 3.1 show the passage probability for QMV in the current and historical EUs. These indicate that although efficiency has been declining, past enlargements have only moderately hindered decision-making efficiency. The last enlargement lowered the probability only slightly, from 10% to 8%, and the Iberian expansion lowered it from 14% to 10%. The figures also hide the fact that the Single European Act, which took effect in 1987, greatly boosted efficiency by implementing majority voting for Single Market issues.

Figure 3.1 also shows what would have happened to efficiency if enlargement occurred *without any reform* of QMV rules. The results – illustrated by the middle bars – show that letting in 12 newcomers without reform would dramatically reduce efficiency, cutting the current passage probability by something like a third, from 7.8% to 2.5%. The intuition for this is simple. Expanding membership increases the number of ways to form a 30% blocking coalition much more

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2 The 14 June 2000 Portuguese President's report on IGC 2000 negotiations states: 'Although delegations' opinions are still divergent on the nature of the solution to be adopted (between a dual majority and reweighting proper), discussions have nevertheless brought to light a degree of convergence on the following: … *the weighting system should not make it more difficult for a decision to be taken within the Council.'* (Emphasis added.) The exact reference is CONFER4750/00, p. 18.

BOX 3.1 Parliament's (non-) impact on efficiency

Enlargement will increase the number of Members of the European Parliament (MEP) from 626 to 732, and one might think that this would make it harder for the European Parliament to act. It turns out, however, that the number of voters does not affect the likelihood of passing a random proposal under one very special, but common, condition. When a body takes its decisions by simple majority as the Parliament does, an increase in the number of voters increases the number of ways to win exactly in line with the increase in the number of ways to block. To see this, note that under the 50% rule any coalition that could block by voting 'no', could win by voting 'yes'. (A bit of reflection reveals that the same does not hold for other thresholds, such as the Council's 71% rule.) Consequently, the number of winning and blocking coalitions changes in the same way. The importance of this lies in its implications for the efficiency effects of adding more MEPs. Under the 50% rule, and only under the 50% rule, raising the number of voters creates a new winning coalition for every new blocking coalition created. As a consequence, the passage probability – the ratio of winning coalitions to total coalitions – is not affected. Of course, this statement reveals the simplicity of our efficiency measure. It does not capture, for instance, the amount of time debates could take with an extra 107 MEPs.

Figure 3.1 Efficiency reforms agreed at Nice in perspective

	EU6	EU9	EU10	EU12	EU15	EU27
QMV: Historical (%)	21.9	14.7	13.7	9.8	7.8	
QMV: No reform (%)					7.8	2.5
QMV: Nice reform (%)					8.2	2.1

QMV: Historical QMV: No reform QMV: Nice reform
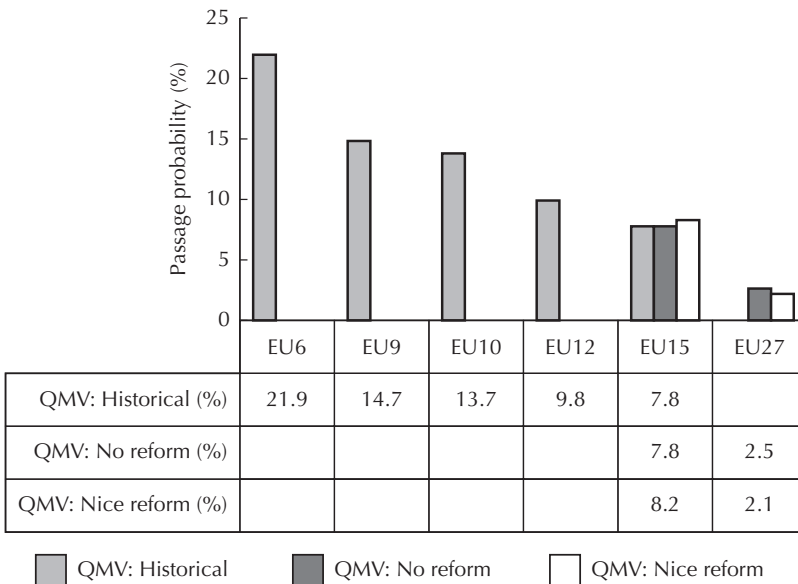
Notes
The figures show the 'passage probability' which measures the likelihood that a randomly selected issue would pass in the Council of Ministers.

The enlargement evaluated is the EU27 (EU15 plus the 10 Central European applicants, plus Cyprus and Malta). Turkey and Switzerland never enter our calculations since their accessions seem a distant challenge.

Source: Authors' calculations.

rapidly than it increases the number of ways to form a 71% winning coalition. Moreover, the gap between these numbers increases with the initial membership. This is a clear-cut implication of the mathematics of combinatorics and it means that any future enlargements will have a much larger effect on the Council's ability to act than did past enlargements.

To put it in more colloquial terms, enlargement without reform would be like letting in another Spain, two more Greeces, six more Denmarks, another Netherlands and a second Luxembourg; common sense tells us that decision-making is bound to get much more burdensome. The passage probability quantifies this common sense. Note that we are hardly the first to study this; see Kirman and Widgrén (1995) for example.

Efficiency of the new rules: worse than no reform

Finally, we calculate the passage probability for the new rules and apply it to the EU enlarged to include all 12 candidate-nations now negotiating. The results are displayed in Figure 3.1 with the left-most bars.

Our key result is that the Nice reforms will actually make matters worse. Admitting 12 new members without any reform would cut the passage probability to a third of its already low level, namely to 2.5%. With the Nice reforms, the figure drops even further to 2.1%. Of course, there is no practical difference between 2.5 and 2.1, but both numbers are far below the level in the EU15.

Quite simply, the Nice reforms failed to meet the goal of maintaining the efficiency of EU decision-making when the membership nearly doubles.

The 12 countries negotiating membership will not be the last to join the EU in the foreseeable future. Turkey and Switzerland have submitted applications, and a handful of Balkan nations will surely apply in the next ten years or so, including Albania, Bosnia, Croatia, Macedonia and Yugoslavia.[3] Iceland came close to applying in the last round and in 1994 Norway negotiated and initialled an accession treaty (so Norway was accepted) but this was subsequently rejected by a national referendum in Norway. Some of the former Soviet republics, such as Ukraine and Moldova may also put in applications a decade or so down the road.

Given this, we explore the Nice reforms' performance in an EU36. Taking the 27 points of comparison in the Nice Treaty's protocol on enlargement, it is easy to guess the number of votes that would be allocated to Norway, Iceland, Albania, Bosnia-Herzegovina, Yugoslavia, Croatia, Macedonia, Switzerland and Turkey. Using these we calculate the passage probability. Our results show that the passage probability in an EU36 would be just nine-tenths of 1%; about a tenth of its current level.

A second, cruder but more transparent efficiency-measuring tool – i.e. blocking minority analysis – confirms our efficiency findings. Before turning to this alternative measure, however, we use the passage probability to identify the source of the efficiency loss.

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3 Despite the 1994 and 2001 negative Swiss referenda, Switzerland's application has not been withdrawn and the Swiss government is officially committed to joining in the medium or long term.

3.1.3 **Sources of the efficiency loss**

The post-Nice rules contain one step forward and two steps backward in terms of their impact on efficiency. These are:

- **Forward**
  - *Reweighting in favour of large nations*: This tends to improve efficiency. To see this compare two extreme vote allocations, one where votes are very dispersed (evenly distributed, to be specific) and one where they are very concentrated (one nation has all votes, to be specific). Although the votes-concentrated allocation would be illegitimate, it would plainly be more efficient in the sense that such a Council would have an easy time taking decision. Since the Nice reforms shifted the vote allocation in the direction of vote concentration and away from vote dispersion, this aspect of Nice tends to enhance efficiency.
- **Backward**
  - *The introduction of two new criteria that a qualified majority must meet – namely members and population.*
  - *An increase in the threshold for Council votes from 71% to 74% (for EU27).*

  Both of these are steps backwards in terms of efficiency, a point that is easily understood since both make it easier to block a decision.

A natural question is: What aspects of the Nice reforms were most responsible for the massive loss of efficiency?

As it turns out, adding in the two new criteria – 50% of members and 62% of the population – had little to do with the loss of efficiency. The main culprit is the increase in the Council vote threshold which had an anti-efficiency effect that overwhelms the pro-efficiency effects of reweighting.

To see this, we must look at how often each of the three majority criteria is the unique binding constraint. In other words, how often is it the case that a given coalition would have won were it not for, say, the population criterion? For example, in the EU27 the 13 largest nations will have enough votes to pass the 74% threshold and enough population to pass the 62% barrier, but such a coalition would be one nation short of the 50% of members criteria. In such a case we can say that the member-criterion matters since it makes it harder to come to a decision. Such situations – where a coalition would win but for the population or member criteria – are quite rare, however.

In the EU15, there are 32,768 possible coalitions all together and, using the Nice vote allocation, about 3000 of them could pass the vote threshold (169 Council votes). Yet not a single one of these 3000-odd winning coalitions fails to satisfy the 50% member criterion (any coalition that has at least 169 votes contains at least eight members); and only 15 of them fail to satisfy the population requirement. Thus in the EU15, the member criterion has no effect on the number of blocking coalitions and thus no effect on the passage probability. The population criterion only reduces the number of winning coalitions by 15 and since eliminating 15 out of something like 3000 winning coalition is unimportant, we can conclude that the population criterion also has a minimal effect on EU15 efficiency under post-Nice rules.

In the EU27, the numbers are even more striking. Here there are 134,217,728 coalitions all together and about 2.7 million of them would be winning using the Council vote majority criterion. Among the 2.7 million coalitions that meet the

vote criterion, only 23 fail on either the population or member threshold; 16 fail to satisfy the majority of member states criterion and 7 more fail on the population criterion. What this means is that the population and member thresholds almost never matter; after all 2.7 million minus 23 is basically 2.7 million.

Table 3.1 shows the precise passage-probability implications. The first line evaluates what the efficiency (as measured by the passage probability) would have been if the Nice meeting had adopted something like the double majority proposal, i.e. *only* the two 'safety net' criteria (62% population and majority of members). Given the relatively low thresholds, such a reform would have greatly boosted efficiency from its current level of 7.8% in the EU15 – the figures in the EU15 and EU27 would have been 23.2% and 19.1% respectively. By contrast, we may ask what the passage probability would have been if Nice had omitted the population and member safety-net completely and continued with the current system of considering only Council votes. The results are shown in the 'no reweighting' row of Table 3.1. Without reweighting and without the safety net, the passage probability would have sunk from its current value of 7.8% to 2.5% in the EU27. The next row considers the impact of reweighting in isolation. That is, suppose Nice had left the threshold at 71% and omitted the safety net, but reweighted the votes as they did. As argued above, reweighting *per se* improves efficiency and this shows up in the table since the numbers for the EU15 and EU27 are 8.3% and 3.5%, both of which are above their no reweighting correspondents.

The impact of raising the vote threshold can be seen by comparing the third and fourth rows. In the EU27, the higher threshold has a substantial impact on efficiency, lowering it from 3.5% to 2.1%. Finally, the total effect of applying the Nice Treaty rules to the EU15 and EU27 are shown in the last row. In the EU27, adding in the safety net has no substantial impact; i.e. the passage probability with reweighting plus 74% is the same at any reasonable level of precision as reweighting plus 74% and the safety net. As mentioned above, the reason is that these extra criteria almost never matter.

Table 3.1 Decomposing the impact of Nice changes on efficiency

	Passage probability in the	
	EU15 (%)	*EU27 (%)*
Safety nets alone	23.2	19.1
Vote criterion alone (as under current QMV rules)		
● No reweighting with 71% threshold	7.8	2.5
● Reweighting with 71% threshold (246 votes to win in EU27)	8.3	3.5
● Reweighting with 74% threshold (255 votes to win in EU27)	n.a.	2.1
Total Nice reform (three criteria and 74%)	**8.2**	**2.1**

Notes
Safety net refers to the 62% population and 50% members criteria.
Vote criterion refers to the number of Council votes.
At the one digit level of precision, adding the safety nets to the reweighting plus 74% threshold has no effect on efficiency.

Source: Authors' calculations using IOP 2.0 program developed by Thomas Bräuninger and Thomas König, http://www.uni-konstanz.de/FuF/Verwiss/koenig/IOP.html.

To summarize, the Council voting reform is dominated by changes in the allocation of Council votes and the change in the threshold. Minimum requirements in terms of the number of countries and population have negligible impact.

3.1.4 Cruder efficiency measures: blocking coalition analysis

On most issues, the newcomers are just as likely to disagree with each other as they are to disagree with incumbents. On certain issues – like structural funds for training government officials and money for cleaning up the environment – they are likely to have similar views, however. It is therefore of some interest to see if an alliance of Easterners would have enough votes to block Council decisions.

There is another issue where a natural alliance might arise. The EU spends half its budget on agriculture with most of this going to rich farmers in rich northern European nations. The figure used to be much higher, but poor incumbents managed to re-orient an important share of agriculture spending towards poor regions. It seems possible, therefore, that the poor newcomers will team up with the incumbent poor-4 to get at the CAP cash; the moral force of cohesion and lots of Council votes will, after all, form a potent pair. Who knows, maybe this would take the form of a 'Solidarity Fund' to complement the Cohesion Fund.

How much blocking power would these two coalitions have?

Figure 3.2 shows that a coalition of poor nations would easily be able to block any decision in the Council. On the number of members criteria, they will have 2 more than the 14 needed to block, and on the votes criteria they will have 80% more votes than they would need to block any proposal. On the population criteria, not even the poor-coalition could block, but this does not matter; a measure can be blocked by any of the three thresholds. A coalition of East nations will be able to block on Council votes.

Smallest blocking coalitions post-Nice
Another way of illustrating how easily decisions can be blocked is to look at extreme coalitions – this was often done in the IGC and at the Nice summit. The idea here is to find, for each threshold, the smallest coalition – both in terms of the number of members and the population share – that can block any proposal. The results are shown in Table 3.2.

The first column of the table shows that when it comes to the Council vote threshold, a coalition of members made up of the smallest nations could block any decision despite the fact that they represent just 13.7% of the EU population. At the other end, a coalition made up of just the four biggest members, i.e. just 14.8% of the member states, could block any proposal on the basis of Council votes. Likewise, the third column of numbers shows that the 14 smallest members of an EU27 could block even though they account for about a ninth of EU citizens.

Given the recent willingness of Germany to play a role that is more commensurate with its size, another potential coalition whose strength it is worth considering is the group of countries that might naturally be considered to line up with Germany on certain issues, such as taxation and social policy. For instance, in the EU27 the coalition of Germany plus the Visegrad-5 (Poland, Czech Republic, Slovakia, Hungary and Slovenia) has only 6 members and 148

Figure 3.2 Blocking power of East and poor coalitions in the EU27
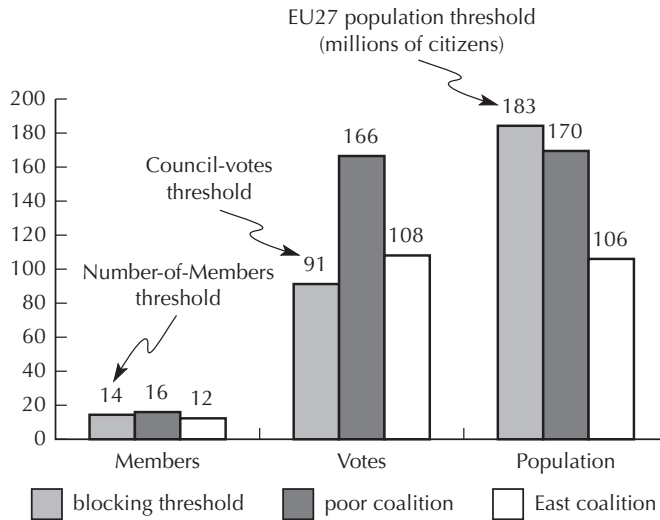
Notes
The leftmost bar in each group shows the number necessary to block a QMV decision for the number of members, number of votes and share of population criteria, respectively. The middle bar in each group shows the size of a coalition of all poor nations (the incumbent 'cohesion' nations plus the 12 newcomers) for each of the three ways to block. The leftmost bar shows the size of the 'East' coalition (12 newcomers).

Source: Authors' calculations.

Table 3.2 Efficiency and Nice reforms: minimum blocking coalitions in the EU27

	Blocking based on:		
	Number of Council votes (%)	*Population share (%)*	*Number of members (%)*
% of EU population in the smallest blocking minority	13.7	38.1	11.6
% of EU members in the smallest blocking minority	14.8	22.2	50.0

Source: Authors' calculations.

million people – not enough to block – but it could block on votes since it would have 91 Council votes. If we add in Austria, the totals rise to 7 states, 157 million people and 101 votes. Alternatively, if we start with members of the old Deutsche mark-bloc who are now EU members, the Netherlands, Denmark, Austria and Germany and add in the Visegrad-5, we arrive at totals of 9 states, 178 million and 121 Council votes. While these figures are a long way from a qualified majority, the number of Council votes is substantially more than is needed to block.

Once again we conclude that legislating under the Nice rules will be very difficult.

3.1.5 Extension of majority voting

For its first ten years, the EEC (as it was known at the time) made most decisions by unanimity among the Six. This worked reasonably well if for no other reason than the fact that the Treaty had already programmed dates and targets for the EEC's first order of business – formation of the customs union. In anticipation of the difficulty of agreeing detailed implementation of deeper integration, however, the Treaty of Rome committed members to an important expansion of the range of issues subject to QMV. This was not to be.

Under the leadership of President de Gaulle, France refused to allow measures to be adopted by qualified majority via its well-known 'empty chair' policy. To avert a crisis that threatened the EEC's existence, the other five members agreed to France's demand for a veto. This was the so-called Luxembourg compromise, an extra-legal Treaty revision that *de facto* crossed out several Treaty of Rome provisions. The result of this was the famous period of 'Euro-sclerosis' in the 1970s and early 1980s during which EU decision-making was essentially paralysed, especially on issues concerning deeper integration.

Majority voting came back with the Single European Act and its application has been progressively widened, often in tandem with extension of the Parliament's co-decision authority.

Nice was supposed to be a continuation of this trend. It was not.

Passage probability under unanimity

We cannot formally judge how much more efficient the EU would have been if QMV had been extended to most areas since we cannot know how likely it is that proposals in such areas would have been forthcoming. What we can easily show is how much more efficient QMV is than unanimity for a random proposal.

The QMV efficiency level was given above in Figure 3.1 and we wish to compare this to the passage probability under unanimity. It is trivial to find the passage probability when the unanimity rule applies. If there are three voters and each has a 50–50 chance of voting 'yes' on a random proposal, then the chance that all three will vote 'yes' on a random proposal is 0.5 times 0.5 times 0.5, or 0.5^3 for those who remember their powers. In an EU of 15, the passage probability with unanimity is 0.5^{15} which is a very small number (three-thousandths of 1%). In the EU27, the number is basically zero. Indeed one needs scientific notation to report the passage probability (it is 7.45% divided by 10 million). Given this, it is not hard to understand why the Commission was so keen on getting most issues shifted to QMV.

The Nice Treaty changes in Council voting rules failed to maintain the enlarged EU's ability to act. Despite this, the Nice reforms will matter. Any change in voting rules redistributes power. So the natural question is: who won and who lost at Nice? This is the subject we turn to now.

3.2 Winners and losers

What is the most important thing in the world that is impossible to measure precisely? Love is surely in first place, but political power is probably a close second. This immeasurability, at least when it comes to power, is a serious problem. The distribution of political power is the key to evaluating the Nice outcome – the

key to democratic legitimacy, and the key to political acceptability. This section uses an admittedly crude quantitative measure to gauge the Nice Treaty's impact on the distribution of power in the Council of Ministers.

Our findings are easy to summarize and not surprising. The Treaty of Nice shifts power from small EU members to big ones in an important way. This power loss was not easy for the small members to accept, but it might have been justified in the name of preserving the EU's efficiency and eastern enlargement – a goal that many EU nations, including many small nations, viewed as worthy of a certain degree of sacrifice.

In the final hours of the Nice summit, small members faced the choice between accepting an important reduction in their power and being blamed for a 'failure' at Nice that would have delayed enlargement. This is ironic. As we showed above, the Nice reforms do not maintain EU efficiency – they worsened it. In this sense, Nice was merely a 'façade reform' that allows EU leaders to claim that the EU is now ready for enlargement. A sufficiently cynical observer might characterize this as a bald power-grab by the large EU members; the small member nations sacrificed real power in order to erect a façade of efficiency. From the point of view of both efficiency and small country power, things would have been better with no Council reform at all.

To make these points, we start with a thumbnail sketch of our power-measuring tools, before using them to measure the Nice Treaty's impact on power in the second section.

3.2.1 Your 'muscles in Brussels': power tools

The first step towards measuring power is to define it.

For our purposes, power means influence, or more precisely the ability to influence EU decisions by being in a position to make or break a winning coalition in the Council of Ministers. Of course, no one has absolute power in the EU, so we focus on the likelihood that a member state will be influential. That is, France may be critical on some decisions but irrelevant on others and the same holds for every member ranging from Luxembourg to Germany.

What determines how likely it is that a particular nation is influential? Voting weights are one obvious candidate, and this rough-and-ready power measure has the great merit of transparency. Unfortunately, voting weights can give a very misleading depiction of the power distribution.

Vote shares as a power measure: the shortcomings
To illustrate the potential pitfalls of vote-weights as a power measure, consider a toy-model of the Council. Suppose there are only three countries in this toy model – imaginatively called A, B and C – and they have 40, 40 and 20 votes respectively. Decisions are made based on a simple majority rule (50%+ to win). If we used voting weights as a measure of power, we would say that countries A and B with their 40 votes were twice as powerful as C with its 20 votes. This is wrong.

With a bit of reflection you can convince yourself that all three nations are equally powerful in this toy Council. The point is that *any winning coalition requires two nations, but any two nations will do*. Likewise, any pair of nations can block anything. As a consequence, all three nations are equally powerful in the sense that they are equally likely to make or break a winning coalition.

More generally, power – i.e. the ability to make or break a winning coalition – depends upon a complex interaction of the majority threshold and exact distribution of votes. For example, continuing with our toy model, raising the majority rule from 50% to 75% would strip nation C of all power. The only winning coalition that C belongs to is the grand coalition A&B&C but here C is not able to block it by leaving the coalition. Therefore, C's vote can have no influence on the outcome. Again, vote shares in this example would give a very incorrect view of power.

Simple counter-examples such as these led to the development of a more sophisticated power index – the 'Normalized Banzhaf Index' – to which we turn next.[4]

Power to break a winning coalition: the Normalized Banzhaf Index (NBI)

In plain English, the Normalized Banzhaf Index (NBI) gauges how likely it is that a nation finds itself in a position to 'break' a winning coalition on a randomly selected issue.

Why would anyone think that this measures power? Power comes in two flavours, positive – the power to get your way – and negative – the power to ensure others do not get theirs. The ability to break a coalition can help you in both ways. First, a nation that can frequently break the winning majority is more likely to be able to block those proposals it disapproves of. Moreover, the threat of breaking a winning coalition can be used to line up allies on future issues – what is know more colloquially as 'back scratching' and 'horse trading'. Box 3.2 describes how the NBI is calculated.[5] Appendix 2 works through NBI calculation in a simple example and provides the exact numbers for all historical EUs.

BOX 3.2 Calculating the Normalized Banzhaf Index (NBI)

The mechanical calculation of the NBI is easy to describe and requires nothing more than some patience and a PC with lots of horse-power. To work it out, we ask a computer to look at all possible coalitions (there are 32,768 in the EU15 and over 134 million in the EU27) and identify the winning coalitions. Then, focusing only on the winning coalitions, the computer works out all the ways that each winning coalition could be turned into a loser by the defection of a single nation. Finally, the computer calculates the number of times each nation could be a 'deal breaker' as a fraction of the number of times that any country could be. The theory behind this is that the Council decides on a vast array of issues, so the NBI tells us how likely it is that a particular nation will be critical on a randomly selected issue.

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4 There are two classical power indices in the literature, the Banzhaf index, which is due to Lionel Penrose (1946) and the Shapley-Shubik index, which was developed by Lloyd Shapley and Martin Shubik (1954); John Banzhaf (1965) invented the index without knowing Penrose's work. We work with the Banzhaf concept since it better explains the data (see Appendix 3).

5 All power index calculations have been done by using the Indices of Power IOP 2.0 program developed by Thomas Bräuninger and Thomas König (2001). The program can be downloaded at http://www.uni-konstanz.de/FuF/Verwiss/koenig/IOP.html.

For the EU15, it turns out that the rough-and-ready measure, namely vote-shares, and the theoretically superior measure (Banzhaf) are not very different, as Figure 3.3 shows. The measures also are quite similar for the EU27. Readers who distrust sophisticated concepts should find their confidence in the Banzhaf measure bolstered by this similarity. The same goes for readers who distrust rough-and-ready measures.

Where does Parliament come into the picture? It turns out that it does not, as Box 3.3 explains.

Figure 3.3 Comparing power measures (pre-Nice): Normalized Banzhaf Index and vote shares

	Germany	United Kingdom	France	Italy	Spain	Netherlands	Greece	Belgium	Portugal	Sweden	Austria	Denmark	Finland	Ireland	Luxembourg
NBI (%)	11.2	11.2	11.2	11.2	9.2	5.9	5.9	5.9	5.9	4.8	4.8	3.6	3.6	3.6	2.3
Vote share (%)	11.5	11.5	11.5	11.5	9.2	5.7	5.7	5.7	5.7	4.6	4.6	3.4	3.4	3.4	2.3
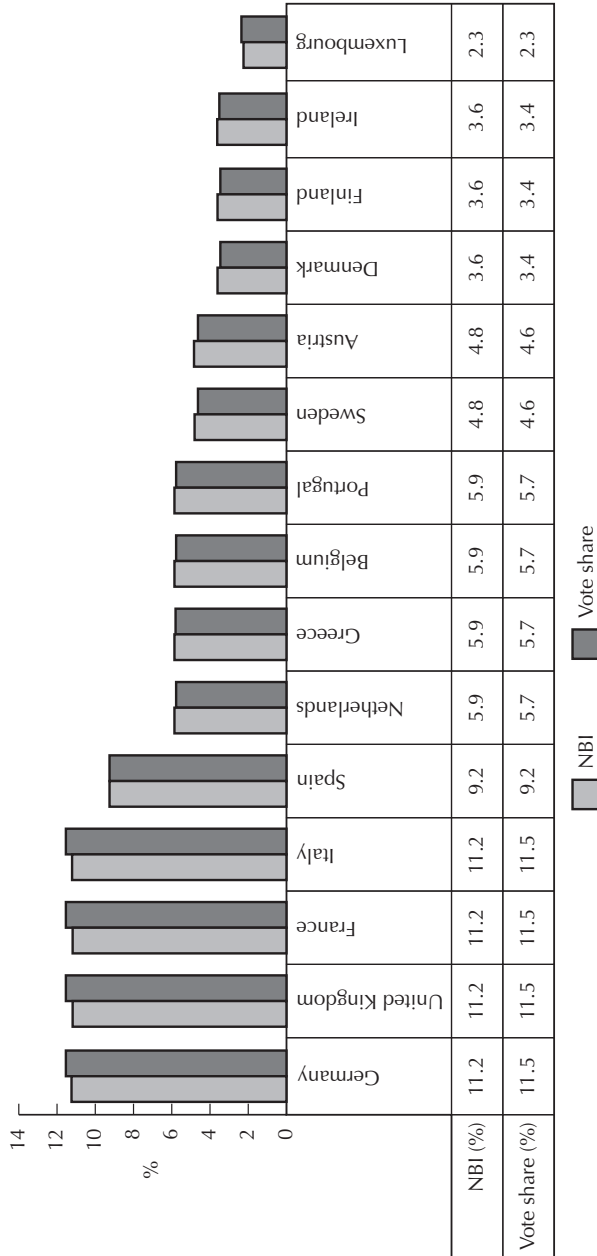
Source: Authors' calculations.

BOX 3.3 Why Parliament reform does not affect national power distributions

Figure 3.4 Allocation according to Nice reforms
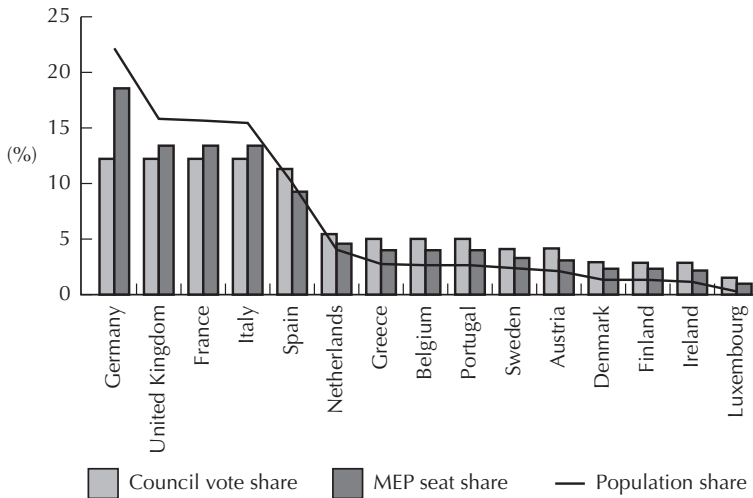
Source: Treaty of Nice, Protocol on the enlargement of the European Union.

Readers familiar with the EU legislative process will realize that most EU legislation these days must be approved by both the Council and the Parliament. The Nice Treaty reallocated Parliament seats, so one might think that this should be taken into account when considering Nice's full impact on national power. This is not so and the reason rests on three facts: (1) The national distribution of Council votes and MEP seats is quite similar, as the figure shows; (2) to pass the Council, a proposal must garner at least 71% of votes, rising to 74%; and (3) to pass the Parliament, a proposal needs to win only half the MEP votes.

   To illustrate this, we must cover a few preliminaries before getting to the main point. First, we start with a simple assumption – that MEPs act as national representatives and indeed that their votes are controlled directly by national governments (obviously this is false, but going to this extreme helps build intuition for more realistic cases). Second, recall that we define power as the ability to break a winning coalition, so the question is: 'Can a nation use the votes of its MEPs to block a coalition that it cannot otherwise block?' If the answer is 'no', then the votes of MEPs do not affect a nation's power, even under the extreme assumption that MEP votes are controlled by governments. Of course, if national power is not affected by MEP votes when they are directly controlled, national power is certainly not affected when the MEPs vote their own conscious. Finally, we assume each nation's share of Council votes is *identical* to its share of MEP votes (rather than just similar).

   Under these assumptions, we can think of the actual procedure as a quadruple majority system. To pass, a proposal needs to attract that votes of member states that have at least: (1) 50% of MEP votes, (2) 71% of Council votes, (3) 50% of members, and (4) 62% of the population.

(Box 3.3 continued)

Now here is the main point. Criteria (1) is redundant since the Council vote threshold is higher than the MEP threshold. That is, since the distribution of Council and MEP votes is assumed to be identical, any coalition that has 71% of Council votes will automatically have 71% of MEP votes, which is plainly more than the 50% necessary.

Some careful thought and a little mental gymnastics reveal the implications of this for national power – there are no instances when a nation's MEP votes increase its power to block. In every instance where it can block on the basis of MEP votes, it can also block on the basis of Council votes.

Now even under a more realistic view of the process, the same conclusions hold. The fact that the distribution of MEP votes is similar to the distribution of Council votes teamed with the fact that the Council threshold is much higher than the Parliament's threshold, means that an MEP's vote could never increase a nation's ability to block, even if the MEP voted on strictly national lines.

Interestingly, this suggests one indirect reason why the Parliament has tended to form cross-national coalitions. If they acted on purely national lines, MEPs would, on typical issues (i.e. where the national government accurately represents the national view), act as rubber stampers. If they form cross-national coalitions, they may bring something new to the process.

3.2.2 Empirical evidence on the relevance of the NBI

The NBI may sound like the typical sort of construct that leads practical men and women to ignore academic writing. There is, however, some fairly convincing evidence that the NBI actually captures power in a meaningful way and this section presents it. Readers who need no further convincing, or those in a hurry to get to the 'meat' can skip this section; the next section shows who won and lost at Nice.

How to test a power measure
Power is impossible to measure directly, but its impact on the world is unmistakable. In particular, budget allocations are one manifestation of power that is both observable and quantifiable. Here is the argument. Voters want more money to be spent in their constituency, so successful politicians use their political clout to direct money homewards. Assuming that EU politicians do use their power for this purpose (*inter alia*), EU budget shares should reflect the distribution of power. Note the important difference here. We are not concerned with budget shares, *per se*. We are interested in them only as a quantifiable manifestation of power since this permits statistical testing of various power measures on historical data.

To form a mind's-eye picture of the link between a nation's NBI and its budget share, the following may help. Suppose that each time a country is critical to winning on any Council decision, it gets a little political 'gift'. This ends up as money in the data, but the actual payment mechanism might be quite subtle – e.g. a more favourable treatment in the allocation of EU subsidies to hillside farmers, a more generous allocation of low-fat milk dairy quotas, or inclusion of reindeer meat in the CAP's price support mechanism. In this light, a country's

NBI should line up with its budget share. A sufficiently cynical analyst can push this reasoning to a stark and empirically testable hypothesis. If one takes the rather extreme view that the entire EU budget is just a proverbial 'pork barrel' filled with political gifts, we should expect each nation's shares of the EU budget to *exactly equal* its power index since both are measured in percentages.

Of course, people who read the serious European press will tell you that this 'pork barrel' view of EU spending is absurd. 'Power in the Council has nothing to do with EU spending' they might tell you, 'EU budget priorities are based on high-minded principles'. In this 'Father Christmas' world view, the EU hands out cash to poor regions to help them cope with Europe's economic integration, and it subsidises EU farmers to guarantee food supplies and to share the fruit of integration with rural Europe. The statistical evidence (in Appendix 3) shows that this belief is almost entirely wrong; the historical EU budget can almost completely be explained by power politics.

Even without formal statistical measures, we can see that power politics does seem to have an important role in the allocation of EU spending.[6] Figure 3.5 shows the EU spending *per capita* and our power measure *per capita* (NBI divided by population) for the EU12 and EU15. The EU12 *per capita* power and *per capita* receipts data, shown in the left panel, line up remarkably well. Greece, Spain and France get a little more than their power share would suggest, and Luxembourg and the Netherlands get significantly less, but overall the fit is quite good. Similar figures for the EU15 (not shown) line up somewhat less well. In particular, the new members, Austria, Finland and Sweden, do not seem to have had time to use their power to bring home their share of expenditure.

We take this as evidence that the NBI captures power in a meaningful way. Readers who accept this should read on to see how the Nice reforms will shift

Figure 3.5 *Per capita* budget shares and NBI in the EU12
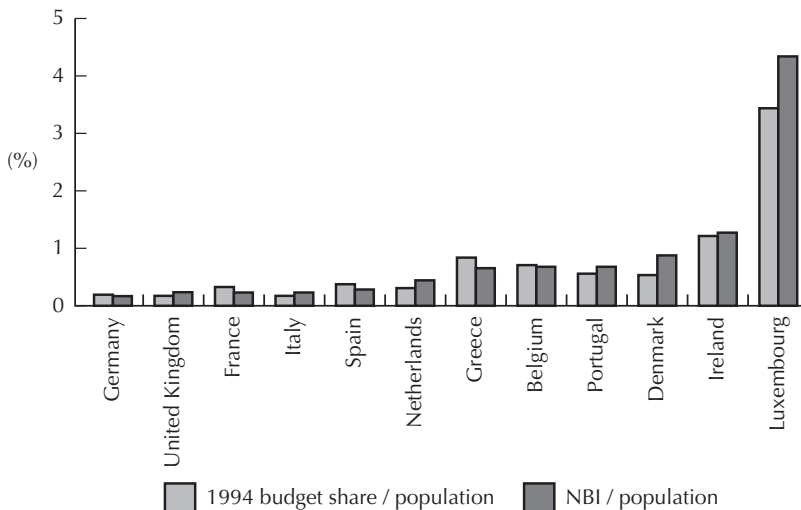
Source: Authors' calculations.

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6   See Baldwin (1994, Chapter 7) on this type of analysis.

power among EU incumbents. Readers who are still sceptical might want to refer to Appendix 3 to see a more detailed and more formal statistical analysis of the power-pork connection and comparison to the Father Christmas model.

3.2.3 Who won?

Among incumbents the biggest losers in Nice, according to our quantitative metre-stick (NBI), are the middle-sized nations, i.e. those with about 10 million citizens. As Figure 3.6 shows, the biggest winner – biggest by far – is Spain, followed by Germany in a distant second place. The Big-5 clearly came out ahead and all the other nations lost. Of the losing nations Netherlands and Luxembourg faired better than average. Exact figures are listed in Appendix 2.

Unless enlargement is greatly delayed, this impact on the EU15 will not be very long-lived since the changes do not take effect until 2005. More relevant for the long run is the impact in the EU27. The figures plotted in Figure 3.7 show the difference between what the NBI will be for each nation with the Nice reforms and what they would have been without reform of the Council voting system. As a comparison of Figures 3.6 and 3.7 shows, the impact in the EU27 is quite different to the impact in the EU15 (exact numbers are in Appendix 2).

First, the reform does not significantly dampen the power of medium-sized countries, i.e. those in the 3-vote, 4-vote and 5-vote clusters. Second, the smallest nations lose more than the mid-sized nations. Overall, the reform seems to redistribute power from the smallest countries, like Latvia, Estonia, Slovenia, Cyprus, Luxembourg and Malta, to the biggest countries, like Germany, France, the United Kingdom, Italy, Spain and Poland. Note that Spain and Poland are easily the largest winners.

These figures show how small changes can have a significant impact on power. One of the last difficult questions tackled at the Nice summit was the relationship between the voting weights of the Netherlands and the other countries

Figure 3.6 Winners and losers in the EU15
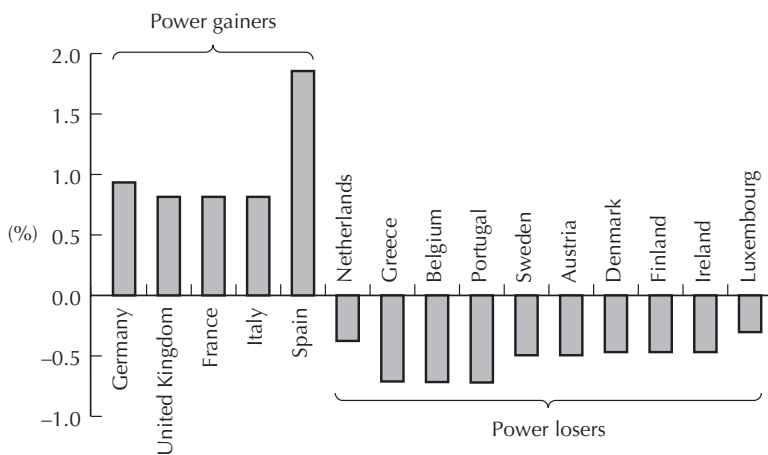
Notes
The bars show the changes in power, comparing power under the Nice reforms to power with no reform (NBI is the power measure).

Source: Authors' calculations.

Figure 3.7 Winners and losers in the EU27

in the old 5-vote cluster, especially Belgium who had shared membership of this group with the Netherlands since the Treaty of Rome. Finally, the Netherlands (which has 50% more citizens than Belgium) got 13 votes, one more than Belgium. Figures 3.6 and 3.7 show that this matters in terms of power. One extra vote means that the Netherlands loses only half as much power as Belgium in the EU15. In the EU27 the effect of the extra vote is even more striking, as Figure 3.7 shows. According to our calculations, the Nice reforms boosted Dutch power in the EU27 relative to what it would have been without reform. Belgium and the other countries of the old 5-vote cluster, by contrast, are found to be made worse-off by the Nice changes (see Figure 2.1 for membership of this cluster). The differences, however, are quite small.

Another interesting aspect is how the reform affects Germany's power compared to the other big countries in the old 10-vote cluster. The Nice outcome on this point was not obvious. Germany and France both got 29 votes, but the dual majority system, which was also adopted, favours Germany as it is more populous than France. As we can see in both Figures 3.6 and 3.7, there will be virtually no difference between Germany's power and that of France. The reason is that the population and member 'safety nets' are largely irrelevant, as we demonstrate above.

As we did with the passage probability, we also calculate the power distribution for the EU36 (EU27 plus Norway, Iceland, Albania, Bosnia-Herzegovina, Yugoslavia, Croatia, Macedonia, Switzerland, and Turkey).[7] The results are shown in Appendix 2.

Overall effect: the Council and the Commission

Our calculations hereto have assumed the Commissioners act the way the Treaties say they should – as a group of independent experts interested in protecting the Treaties and advancing the cause of an ever-closer EU. This is not the only way to think about the Commission, however.

The Amsterdam Treaty, for example, explicitly links Commissioners per nation and Council votes;[8] and during the IGC 2000 negotiations a major reweighting proposal explicitly suggested that the second Commissioner for big nations was 'worth' five extra Council votes. Additionally, the squabbling in Nice over the number of Commissioners suggests that having a Commissioner may affect national power.

So, how will the loss of the second Commissioners affect the power of big members? The surprising answer is, not at all. To clarify our thinking on this, consider two extreme assumptions: (1) Commissioners either are national representatives, or (2), Commissioners are completely independent. Obviously if (2) holds, the loss of a Commissioner has no impact on national power, defined narrowly as the ability to break a winning coalition. Now if (1) holds, more involved reasoning is required.

The Commission decides on a simple majority, so assuming (1) and the Nice rules that allocate one Commissioner per member, a proposal that makes its way into law requires – *inter alia* – that half the members 'instruct' their Commissioners

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7 The calculation necessary for these numbers rapidly becomes unmanageable. It took 85 hours of computing on a 933 megahertz PC to generate these numbers.

8 Article 1 of Protocol 11 says that the Commission will comprise one national from each member provided that Council votes have been reweighted in a manner acceptable to all nations.

to vote 'yes' (member states cannot instruct their Commissioner, but making this extreme assumption helps build intuition for more realistic cases). After Nice, however, QMV in the Council already requires at least half the members to vote for a proposition, so if Commissioners act as national representatives, the 50% of members safety net is redundant. Doing a bit of mental gymnastics, we can flip this around; once the big nations accepted the 50% of members rule in the Council, the loss of their second Commissioner changes nothing in terms of their ability to block. Thus a large country's 'sacrifice' of a Commissioner was partly illusory.

This analysis is certainly incomplete. One can think of many other subtle ways in which a Commissioner boosts national power. For instance, a Commissioner has some agenda-setting power over the proposals that touch on their area of competence. Also, Commissioners make other Commissioners aware of particular national sensitivities, so there was some element of sacrifice in the loss of Commissioners, but it is not nearly as clear cut as it seems at first glance. This reasoning also demonstrates the sort of surprises that can arise when one springs a massively complex voting system on heads of governments without staff preparation.

A cruder but more transparent measure of power

The formal power measure discussed above has many merits, but may not suit the tastes of all readers. For this reason, we look briefly at a cruder but more transparent measure of power, namely vote shares. Table 3.3 shows the results.

It is reassuring that the findings based on this alternative measure of power tell substantially the same story as our more formal power measure. In particular, all the large countries gained, with Spain's power increasing a remarkable two percentage points. All medium and small nations lost power, but the mid-sized members fared the worst of all.

Table 3.3 Measuring power shifts with vote shares

	Vote share		
	Post-Nice (%)	Pre-Nice (%)	Change (%)
Germany	12.2	11.5	0.7
United Kingdom	12.2	11.5	0.7
France	12.2	11.5	0.7
Italy	12.2	11.5	0.7
Spain	11.4	9.2	2.2
Netherlands	5.5	5.7	−0.3
Greece	5.1	5.7	−0.7
Belgium	5.1	5.7	−0.7
Portugal	5.1	5.7	−0.7
Sweden	4.2	4.6	−0.4
Austria	4.2	4.6	−0.4
Denmark	3.0	3.4	−0.5
Finland	3.0	3.4	−0.5
Ireland	3.0	3.4	−0.5
Luxembourg	1.7	2.3	−0.6

Source: Authors' calculations.

The impact of Nice on the power distribution was one of the Treaty's features that was apparent to all (on leaving the summit, Greek Premier Costas Simitis said the reweighting 'represents an effort to create a directorate of big countries'). What is less clear is how this power shift affects the legitimacy of EU decision-making; the topic to which we turn next.

<u>3.3</u> Legitimacy

Current decision-making rules in the Council were set in the year Charles de Gaulle was elected President. These rules gave more voting weight to large nations but *much* less than population-proportionality would suggest. This was quite intentional.

The original Six consisted half of small and half of large nations, and in the 1950s 'over-weighting' small nations seemed a good idea given the abusive behaviour of big European nations in the preceding 90 years. After all, the 'Great Powers' approach and the 'Concert of Europe' were exactly the sort of Europe that the Treaty of Rome was designed to replace. For this reason, a deep respect for the rights of small nations is, and always has been, one of the touchstones of the EU.

This section considers the democratic legitimacy of the post-Nice decision-making system. We start with a brief discussion of what legitimacy means in this context.

3.3.1 Thinking about democratic legitimacy

What makes a decision-making system legitimate?

This is a hard question, so let us start with an extreme and obviously illegitimate voting scheme and think about why it seems illegitimate. Almost every European would consider a system to be illegitimate if it allowed *only* landowning males the right to vote. Why? Because those without votes would find it unjust; and if the landowning men were forward looking, they would also find it illegitimate since they or their offspring might one day lose their land.

Equipotent citizens and two-Union citizenship
In short, a good way to think about legitimacy is to apply the 'in the other person's shoes' rule. A system is legitimate if all individuals are happy with any other individual's allocation of voting power, which, if you think about it, requires equality. Equal power per citizen is thus the legitimacy principle we adopt.

What constitutes a citizen, however? In the EU there are two answers: nations and people. The EU is a *union-of-states*, so each state is a citizen and should thus have equal voting power. The EU is also a *union-of-people*, so people are citizens and so each person should have equal voting power.

The hard part is that the EU is both a union-of-states and a union-of-people and this makes it impossible to apply the equality principle in a simple manner. Note that there is a more classical way to phrase this same point. Democracy, it has been said, is the tyranny of the majority. To avoid this tyrannical aspect, democracies must have mechanisms that protect the rights and wishes of minorities. In the EU, the over-weighting of small nations' votes was one such mechanism. For example,

equality of power per person would grant Germany 2000% more power than Ireland; equality per member would grant Luxembourgers 160 times more power per person than Germans. Given the dual-Union nature of the EU, neither extreme is legitimate.

This two-Union perspective illustrates clearly the inescapable 'legitimacy dilemma' that EU leaders faced in Nice. As a matter of pure logic, shifting power in favour of big nations pushes the system towards greater union-of-people legitimacy, but away from union-of-states legitimacy. By pure genius or dumb luck, the *status quo* QMV-weighting scheme has – since 1958 – steered between the two extremes. It could do this, however, only because the historical size-profile of EU membership was sufficiently compressed to allow one rule to reasonably satisfy two legitimacy criteria. Since enlargement will greatly skew the size profile, the EU was forced to confront the legitimacy dilemma inherent in any weighted voting scheme.

3.3.2 Legitimacy by the numbers

Given our measurement of power (described above), it is a fairly easy matter to measure union-of-people legitimacy and union-of-states legitimacy. An EU that was 100% union-of-states legitimate would give equal power to all members nations. An EU that was 100% union-of-people legitimate would give equal power to all EU citizens. This point is illustrated in Figure 3.8 for the EU15.

The 'fair' power distribution for the union-of-states view is trivial; each member gets 1/15th of the power. For the union-of-people view the calculation is more complex and involves some reckoning to which we turn now.

Figure 3.8 Illustration of 'fair' power distributions for two types of union in the EU15
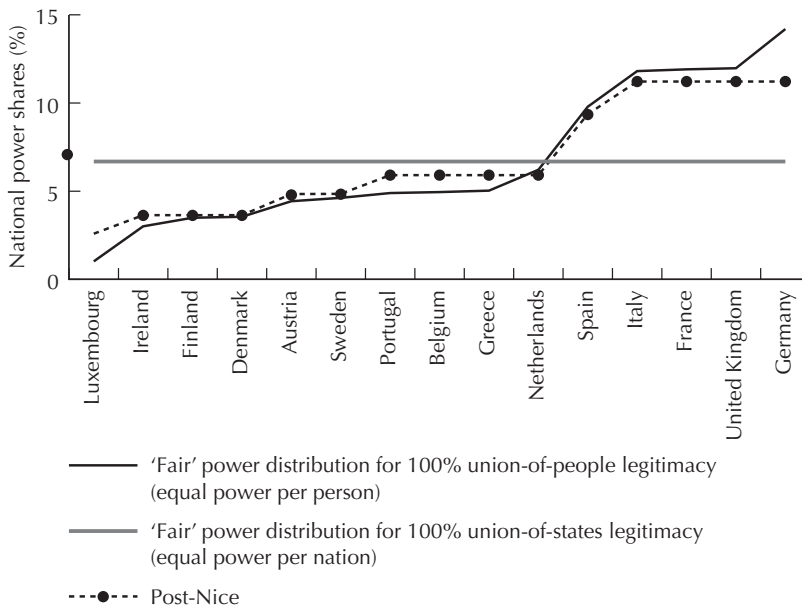
Source: Authors' calculations.

Fairness and square-ness

Strange as it may seem, ensuring union-of-people fairness – that is to say, a Council in which each EU *citizen* has equal power – requires each Council member to have power in Council that is proportional to the square root of her nation's population. Why?

The basic reason is that Council decision-making is a two-step procedure:

- citizens elect national governments, and then
- governments vote in the Council.

This matters.

In her national election, a typical German citizen has less power than a typical Luxembourger. Each group of voters chooses one government but German voters are 160 times more numerous. Thus in national elections, a German voter has much less influence than a Luxembourg voter. To ensure that each EU citizen is equally powerful in Council decisions, the German Council representative must have more power than the Luxembourg representative. That much is easy to see, but how much more?

A first guess is that in her national election, a German voter is only 1/160th as influential as a Luxembourg voter is in hers. In this case, making EU citizens equipotent in the Council would require that the German Minister is 160 times more power in the Council than the Luxembourg Minister. It seems right – 1/160th as powerful in the national election and 160 times more powerful in the Council. This is wrong, however, since it misses a subtlety that requires some mental gymnastics to comprehend.

In national elections, two things change as the number of voters rises. First, the likelihood of being critical in a particular winning coalition decreases and – as intuition dictates – it declines linearly with the number of voters. Second, the number of winning coalitions increases.[9] Thus, the German has 1/160th the chance that a Luxembourger does of making or breaking a given winning coalition, but for the German this is applied to many more coalitions. Taking this into account one can see that the German voter's power is less than that of a Luxembourger in their respective national elections, but the figure is not 1/160th as powerful, it is higher. As a consequence, the German Minister's power in the Council should not be proportional to the German population; it should be *less than proportional*. The precise answer is that for all EU citizens to be equally powerful in the Council, their Ministers should have power in the Council that is proportional to the *square root* of their national populations. This is called Penrose's rule. Admittedly, it is not the easiest concept to grasp, but it is correct and has a cherished position in the mathematics of voting systems; see Box 3.4 for an alternate explanation.

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9 Try a simple example. With three citizens called (A, B and C) a 50% majority rule and one-vote per citizen, there are four winning coalitions when there are three citizens (A&B, A&C, B&C, A&B&C). With five voters there are 11 winning coalitions (A&B&C, A&B&D, A&B&E, A&C&D, A&C&E, A&D&E, B&C&D, B&C&E, A&B&C&D, A&B&C&E, A&B&C&D&E).

BOX 3.4 Fair and square (root): Gestalt of the square root rule

If everything in the Council of Ministers were decided by an EU-wide referendum, proportional representation would clearly provide each EU citizen with equal power. Even ignoring the Commission, however, decision-making in the EU is a two-step procedure – citizens elect national governments, which then vote in the Council – and this changes everything. In their national election, a typical Frenchman is less likely to be influential than a Dane since each chooses one government, but French voters are more numerous. Thus small-nation citizens have a power-edge going into the Council meeting and to even out the power, the votes of big-nation representatives should have more weight in the Council.

But how much more? The formal power measures discussed above yield a simple answer. National power in the Council should increase with the *square root* of national population. The reason is that power per citizen in national elections declines with the square root of the population, so national power in the Council should increase with square root in order to have a fair system, i.e. a system where each EU citizen is equally powerful in the Council of Ministers.

Where, you may ask, does the square root come from? The answer requires a bit of maths. Consider a randomly selected yes-no issue and suppose that member nations decide their stance on this issue by a referendum; define P_N as the probability that a typical citizen's vote is critical in the referendum outcome. Then the member states vote in the Council and define P_{ms} as the probability that the member state is critical in the Council vote. A citizen's probability of being critical is thus P_N times P_{ms} and our fairness metric requires this to be equal for all member states.

P_{ms} has nothing to do with the number of voters (proxied by population), but P_N falls at the square root of population. This sounds peculiar since most numerate people would think the probability of being critical in a national election decreases in a straight-line relationship with population. This misses a subtlety, however. Two things change with the voter headcount. The probability of a typical voter being critical to a particular winning coalition decreases linearly with the headcount, but the number of distinct winning coalitions rises with the number of voters. The probability of being critical therefore falls at a less-than-linear pace. The mathematics of combinatorics gives us an exact formula assuming a voter's stance is randomly determined on a randomly selected issue. Taking M as the minimum number of votes in a winning coalition and n as the number of voters, the formula is:

$$P_N = \frac{M}{n(2^{n-1})} \binom{n}{M}$$

The equation is complex, but can be well approximated as the square root of $2/n\pi$, where n is the number of voters (this is Stirling's formula). Hence the square root.

3.3.3 Two-Union legitimacy: Nice reform vs. historical outcomes

The correct blend of the two unions is not possible to determine objectively, but we can easily compare the post-Nice system to historical blends, as Laruelle and Widgrén (1998) showed. Here is the idea.

Actual power distributions can be thought of as a blend of two extreme power distributions – equipotent people and equipotent states. One way to determine the blend is to consider figures like Figure 3.8. A more objective procedure is to use simple statistical techniques (least squares) to find the blend that best fits the actual power distribution. The results of this are displayed in Figure 3.9. For the EU12, for example, the actual distribution of power among members was 79% (people) and 21% (states) blend of an equal-power-per-member scheme and an equal-power-per-person scheme.

To see how the Nice reforms changed the balance between the union-of-states legitimacy and the union-of-people legitimacy, compare the two leftmost pairs of bars. The blend shifts from today's 78% and 22% blend to a lopsided 97% and 3% blend. This comparison clearly shows that the Nice reform heavily disfavours the union-of-states legitimacy since it transfers much power to large nations. Indeed, the post-Nice system will be far from any of the historical blends. After enlargement the dominance of small nations among the newcomers will raise the blend to 92% (people) and 8% (states) in the EU27.

All this seems clear with hindsight. We turn now to consider why such considerations were ignored in Nice.

3.3.4 Legitimacy in the IGC 2000 preparations

Legitimacy issues played a very large role during the IGC 2000 preparations. Unfortunately, the discussion seems to have been focused on one very particular set of numbers – the minimum population share in a qualified majority (see Box 3.5).

Figure 3.9 Nice vs. the historical two-Union legitimacy blend
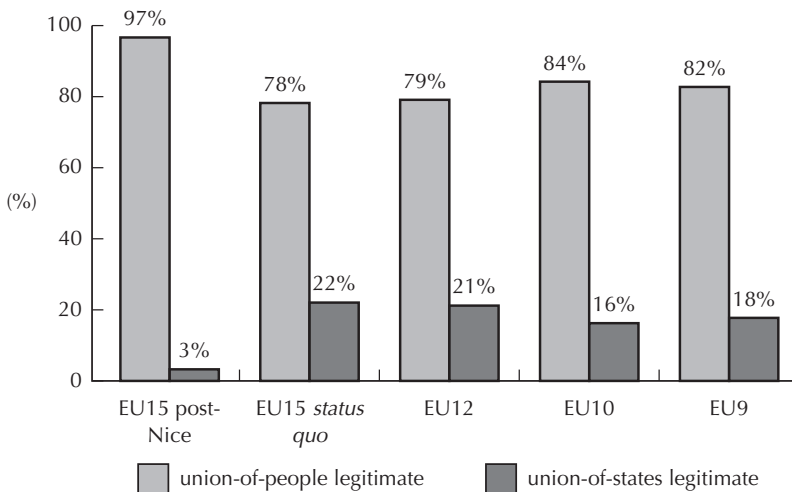
Notes
100% union-of-people legitimacy means equal power per EU citizen; 100% union-of-states legitimacy means equal power per EU member state. By construction, the two measures add to 100%. The figures come from an ordinary least squares regression.

Source: Authors' calculations.

BOX 3.5 Legitimacy in the IGC papers

The notion of legitimacy based on the population share in the smallest qualified majority is found throughout the IGC 2000 documents, but it is quite succinctly expressed in this excerpt from the Portuguese Presidency's report on the IGC (emphasis added):

4. Although delegations' opinions are still divergent on the nature of the solution to be adopted (between a dual majority and reweighting proper), discussions have nevertheless brought to light a degree of convergence on the following:

- any weighting system must reflect the dual nature of the Union, which is both a Union of States and a Union of peoples;

- irrespective of the option chosen, the future system of weighting of votes in the Council must be equitable, transparent, efficient and easily understood by citizens;

- **in order to ensure its legitimacy, any qualified majority must comply with a minimum threshold expressed in terms of population, which must in any event be more than 50%, with opinions diverging as to the specific figure to be adopted;**

- there is a political link between the weighting of votes and other questions dealt with by the Conference, such as the size of the Commission or the apportionment of European Parliament seats, with the result that a satisfactory outcome to this issue can be attained only under a balanced overall compromise;

- the weighting system should not make it more difficult for a decision to be taken within the Council.

Source: CONFER 4750/00, p.18 from http://europa.eu.int/comm/archives/igc2000/index_en.htm

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The thinking seems to have been as follows. The smallest population share in a qualified majority started at something like 70% in the 1950s and remained there until the Iberian enlargement brought it down to about 60% where it remains today. The worrying trend, a trend that has featured repeatedly in the IGC documents, is the fact that this figure would have headed towards 50% in an unreformed EU27 (see Box 3.6). Without reform, even the first-wave enlargement would have brought it down significantly (to 54.2%) since two of the five frontrunners are tiny (less than 2 million) and another two are small (10 million apiece). The fact that about half the EU's populace could pass a proposition that requires 71% of votes was widely accepted as posing a threat to the legitimacy of the system. This was, in fact, one of the major motives for reforming the voting weights in the first place. Such thinking led many to focus on extreme coalitions as the *main* determinant of a system's legitimacy. This is a mistake.

Intuitively, it is illegitimate to have a system where a small fraction of the EU population can force its will on the whole, but this is a very incomplete analysis.

BOX 3.6 Minimum qualified majorities with no reform, EU6–EU27

Figure 3.10 Minimum qualified majority share for population and number of nations

	EU6	EU9	EU10	EU12	EU15	EU20	EU27
Min. population share (%)	68.9	71.4	70.4	59.8	58.2	54.2	50.2
Min. members share (%)	50.0	55.6	50.0	58.3	53.3	55.0	51.9
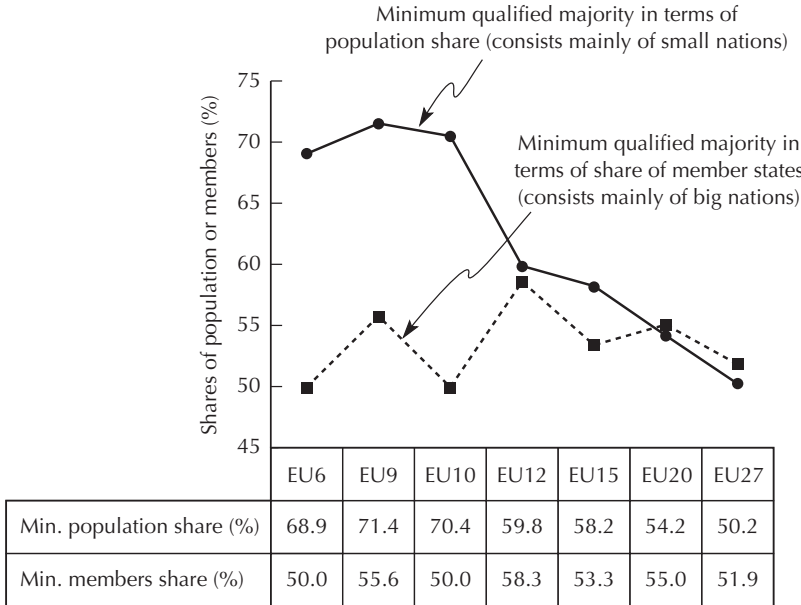
Notes
Figures show the smallest possible qualified majority in terms of population and number of nations, with the pre-Nice weighting system.

Source: Authors' calculations.

The *solid-line* in Figure 3.10 shows the frequently cited 'minimum population share in a qualified majority (QM)'. To find this, one starts with the smallest nations (they have the most votes per person) and proceeds up the size-ranked list until the number of votes is sufficient to win. Given the lumpiness of votes, the final vote count from this procedure often surpasses the minimum number necessary to win, so one drops a nation or two to minimize the population share while still respecting the threshold. The population share of this coalition is the number that is plotted. Importantly, this figure falls when small nations get more votes.

The *dashed line* shows the minimum share of members in a QM. To find this, one starts with the members who have the most votes per nation (the Big-4), and works one's way down the list until the cumulative vote tally passes the QM barrier. The number of nations in this winning coalition, expressed as a fraction of the number of EU members for each historical and future EU, is what is plotted. Importantly, this figure falls when big nations get more votes.

For example, suppose voting system 'A' was marked by the following feature: the coalition of every single small and medium-sized nation could muster a qualified majority (71% of Council votes), while representing only 49% of the EU population. How does this compare to voting system 'B', which differs from 'A' in many ways, one of which is that it has a demographic safety net that rules out such a possibility? If one focuses only on extreme coalitions, it would seem that system 'B' is more legitimate than system 'A'. This misses much, however, since the extreme coalition which is the focus of all this attention is extremely unlikely; the system might operate for decades before it produces a single instance of 49% forcing its will on the majority. Small and medium nations are, after all, as likely to disagree with each other as they are to disagree with big nations. Europeans will judge the decision-making system mainly on its average performance, not just on the avoidance of extreme coalitions.

Of course, extreme outcomes should be avoided, but by focusing entirely on extreme coalitions, EU leaders were 'penny wise and pound foolish' when it comes to defending two-Union legitimacy. The population and member state criteria will rule out extreme coalitions, but it will not ensure that the system – on average – respects the two-Union principle. As we showed above, the reweighting of Council votes and 74% threshold will – year in and year out – disfavour the interests of the EU's small members to such an extent that the dual nature of the EU is no longer respected. Also, if the system is seen as rendering small nations powerless on most issues, the safety net will do nothing to convince small members' citizens of the system's legitimacy.

3.3.5 Summary of legitimacy findings

The EU is a union-of-states and a union-of-peoples. The over-representation of small nations in the Council of Ministers is, and always has been, an essential feature of the EU. The Treaty of Rome, after all, was meant to close the door on the old 'Great Powers' approach to European cooperation. The reweighting of votes in the Treaty of Nice pushes the EU back towards the old Great Power approach and as such it erodes the legitimacy of EU decision-making. Superficially, the 50% of members safety net seems to address the union-of-states part, but as we showed above, this safety net is overshadowed by the vote-share criterion; it has no bite and thus no role in determining member states' influence.

Moreover, a central tenant of democratic legitimacy is transparency. How can citizens trust a system that they cannot understand? On this legitimacy score, the Nice Treaty also fails miserably. The combination of three majority rules, each of them using a different majority threshold, the change in the Council vote threshold and the reweighting of votes further complicates what was an already complex process.

3.4 Summary and comment: what went wrong in Nice?

The decisions made in Nice should have been well prepared.

IGC negotiations were held periodically over almost a year. On the crucial voting-weighting question, however, a strange – or maybe not so strange – deficiency appeared. During the preparatory talks on voting weights, discussions were

fairly abstract. Few concrete proposals or inputs were made and little concrete analysis was performed. Also, importantly, the French Presidency made no specific proposal until the EU leaders were already gathered in Nice. To some, this was a French stratagem aimed at ensuring that Germany's voting weight would not exceed that of France. (Any reweighting proposal based on the logic of democracy ties votes to population and since Germany has 20% more EU citizens than France, any system based on logic would have granted Germany more voting power. When proposals are written down it is almost impossible *not* to study them from a logical perspective, but when they are brought out at the last minute in a meeting of heads of state and government, politics, not logic, is the metric applied.) To others, it merely reflected the fact that voting reform was so politically sensitive that it could not be viewed in isolation from the whole package. Whatever the reason, the result was simple. The proposals made in Nice came too late to allow serious evaluation.

In the early hours of 11 December, the goal of efficiency was forgotten and the leaders' dominant goals seem to have been (1) maintaining or increasing their nation's blocking power, and (2) crafting a deal that could be plausibly presented as a national 'win' to their own domestic audience. The final solution, reached at 4 a.m., was a smashing success on these terms.

The leaders – who had come to think of power as blocking power – solved the power-allocation problem in the same way that printing money allows an irresponsible government to solve its budget allocation problem. The leaders 'printed' blocking rights by creating two brand new ways of blocking proposals and by raising the QMV threshold to 74%. Moreover, the concoction was so complicated that no one – and certainly not the national leaders – fully understood it. Even the final version of the Treaty has numerical inconsistencies in it despite weeks of post-Nice negotiations (see Box 3.7). Of course this complexity proved politically convenient when everyone went home and told their nation that they had 'won'.

BOX 3.7 Numerical inconsistencies in the Treaty of Nice

The deal that was announced in mid-December was so complex that it contained a couple of inconsistencies. These required weeks of post-Nice negotiations to straighten out, and in fact one was so thorny that the leaders agreed to leave the inconsistency in the definitive version of the Treaty rather than solve it!

To be specific, Declaration 20 of the Final Act says the Council vote threshold for the 27 listed nations is 258, but Declaration 21 says that once all the listed nations are in and we have an EU27, the blocking minority is 91, which implies a winning threshold of 345–90 = 255. So is it 258 or 255? General principles suggest that the last word is the ruling word, so we have assumed they meant 255. In any case, this is just a political commitment since the actual number will be set in the accession treaties.

Another oddity is with the threshold expressed in percentages. Declaration 21 says that while the enlargement has not yet been completed (i.e. not all 12 have joined), the Council vote threshold will move:

(continued)

(Box 3.7 continued)

according to the pace of accessions, from a percentage below the current one to a maximum of 73.4%. When all the candidate countries mentioned above have acceded, the blocking minority, in a Union of 27, will be raised to 91 votes, and the qualified majority threshold resulting from the table given in the Declaration on enlargement of the European Union will be automatically adjusted accordingly.

Now the actual threshold is 71.26%, and 91 votes to block in the EU27 implies a threshold of 73.91%, so where does the 73.4% come from?

Not all is darkness, however. One bright spot in the Treaty concerns flexible integration, namely the possibility that subgroups of members can press ahead with deeper integration without waiting for all members and without closing the door to any members. This is the topic of the next chapter.

4 Enhanced Cooperation: A New Integration Engine?

The EU has a diversity problem.

Some EU members have strongly held desires to press ahead with deeper economic liberalization/integration/coordination, others wish to extend EU integration to new areas such as social policy, yet others feel that integration has already reached the level that their voters perceive as far enough.

Enhanced cooperation is the solution to this diversity problem; and the solution comes none to soon. Enlargement will not greatly affect the range of attitudes towards deeper or broader integration, but acting on anything will get much harder given the big drop in decision-making efficiency. This will make it even harder to rely on the old so-called Community approach where Treaty changes and Council directives and regulations are the instruments of integration, especially in areas requiring *de facto* unanimity. A key change in the Nice Treaty is to allow subgroups of members to push ahead with deeper or broader integration without requiring unanimous approval for their endeavour.

Enhanced cooperation may unleash a new and powerful engine of European integration. A new 'Community method', if you will, in which subgroups of members thrust forward and create conditions that may eventually draw in other members. In this new integration method, forward-leaning member states become the initiators and the Commission plays the role of administrator and gatekeeper. Of course, this is not the only possible outcome. These clubs within the club could dilute the value of membership for those who cannot yet join, or those who chose not to join. Moreover, there may be few areas where enhanced cooperation arrangements (ECAs) are likely in the near term – at least we have not seen a convincing list of potential ECAs.

This part of the Treaty might be thought of as the biggest victory of the Commission in Nice. The Amsterdam Treaty gave the Commission *de facto* veto-power over setting up an area of closer cooperation, the power to decide (or at least influence) how and when new members join such groups, and the right to administer them. Since no new closer cooperations were set-up, however, the power was purely theoretical. In making it easier to start these clubs-within-the-club, the Treaty of Nice might have weakened the Commission's role in this, but it did not.

Logic of the chapter

First, this chapter puts the enhanced cooperation solution in the context of the long running debate over Europe's 'diversity problem'. It then turns to some potential pitfalls involved in this sort of differentiated integration and suggests

that the Nice solutions do a good job of avoiding these. The details of the enhanced cooperation – which are largely a reframing of provision from the Amsterdam Treaty – are then presented. Finally, the implications of this for European integration is addressed in the context of an analytic framework that explains how enhanced cooperation might lead to 'snowballing integration' via learning and gravity effects.

4.1 Enhanced cooperation in perspective

The concept of enhanced cooperation is not new. Right from the beginning some deeper integration was allowed among subgroups of members and, more recently, the Amsterdam Treaty formalized the notion as 'closer cooperation'.[1] Enhanced cooperation should thus be viewed as the end-point of a long debate on how to reconcile member's diverse views on the scope, pace and depth of integration.

To appreciate the merits of enhanced cooperation, one must be aware of the alternatives. To paraphrase Winston Churchill's aphorism on democracy, enhanced cooperation may be the worst solution to EU diversity – except for all the others. Over the years, four main ideas have been put forward to deal with this diversity.

- **Europe à la Carte**: the EU should offer a menu of areas of integration from which member states would freely choose. In an extreme version associated with Margaret Thatcher, even the *acquis* could be selectively adopted.
- **United States of Europe**: the EU should go straight for supra-nationalism. This idea, which is diametrically opposed to the Europe à la Carte notion, has little support among incumbents, but did inspire the framers of the Treaty of Rome.[2]
- **Variable geometry**: the EU should separate into a core group of members willing to broaden and deepen European economic and political integration quickly, and a non-core group of more reluctant members. The concept was most clearly advanced by Karl Lamers, a Christian-Democrat German parliamentarian.
- **Multi-speed integration**: Europe's traditional integration mode, advances integration via Treaty amendments. The idea is that some members, especially new entrants, can adopt the common policies gradually, but convergence to a common end-point is not in question since the Treaty changes are unanimously agreed and – ultimately – universally binding.

As an earlier CEPR report in the *Monitoring European Integration* series argued, enhanced cooperation (or flexible integration) is a response to the shortcomings of these four options.[3]

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1   In the late 1950s, the Benelux nations as a group (with their customs union) and Belgium and Luxembourg as a pair (with their monetary union) were leagues ahead of the other EEC-6 members in terms of economic integration and they insisted that the Treaty of Rome sanction this closer cooperation (TEC Article 306).

2   One of the Treaty's main architects, Jean Monnet, headed an influential group bluntly called the 'Action Committee for the United States of Europe'.

3   Under the name 'flexible integration', the enhanced cooperation concept was put forward in Dewatripont et al. (1995).

4.1.1 Drawbacks of the four ideas

The first idea's limitations are obvious. While a sophomoric argument can be made for Europe à la Carte – free choices by informed nations should produce an optimal outcome – this ignores the subtle interconnections among the commitments necessary to create a single market. Like the complex system of stays, shrouds and spars that hold up sails in a big sailing ship, one cannot undo individual elements of *acquis* without risking unexpected effects, including a severe weakening or even collapse of the whole structure. Europe à la Carte would turn EU membership into a spaghetti bowl of commitments that would be difficult to enforce. Worse still, knowing that they might win exceptions to features they find onerous, special-interest lobbying might force a successive unpicking of the internal market.

The United States of Europe notion is fatally flawed for an even simpler reason; it ignores the *de facto* heterogeneity of members' aspirations and ability with regard to deep integration.

The risks of 'variable geometry' became obvious during the process leading to the euro. If Lamers' idea had been adopted, monetary union would be a 'greater Deutschmark area' extended to France, but excluding the other Mediterranean countries – an arrangement which would have divided the EU, possibly forever.

A 'multi-speed Europe' has also become unworkable. Insisting on a common end-point contravenes the clearly and democratically expressed will of EU citizens. Moreover, the method of multi-speed Europe – where deeper integration is embodied in Treaty changes that are accepted by all members, but implemented more slowly by some – is likely to become unworkable in the EU27. This Treaty-modification approach was cumbersome and proved almost fatal in the IGC 2000 with just 15 members. With 27+ members, each with a veto, such IGCs will be much harder, maybe even impracticable.

4.1.2 Squaring the circle: enhanced cooperation

In the enhanced cooperation model, flexibility is *functional* rather than *geographical* (as it is under variable geometry). All member states share a 'common base', i.e. a set of policies, accepted by all members, while other areas of cooperation are organized instead as 'open partnerships'.[4] These allow subsets of countries to cooperate more intensively along specific policy dimensions. In short, enhanced cooperation introduces the flexibility necessary to deal with the membership's heterogeneity, while avoiding a first-class/second-class division. It also creates opportunities for experimenting with new forms of cooperation that might, if successful, attract most or even all members – the European exchange rate mechanism (ERM) and the Schengen Agreement are good examples (more on this 'snowballing integration' below).

4.2 Potential pitfalls and Nice solutions

Enhanced cooperation contains elements of both Europe à la Carte and variable geometry. As such it runs two very serious risks.

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4   The terms 'common base' and 'open partnerships' are from Dewatripont et al. (1995).

- **Divisiveness**. By allowing a separation of members into groups, it risks fragmenting the EU politically.
- **Integration erosion**. By allowing for diversity in integration it risks eroding the consistency of European economic and social integration.

The Nice Treaty, which builds on the firm foundations laid down by the Amsterdam Treaty, has done an excellent job of guarding against the twin risk of divisiveness and integration-erosion without excessively discouraging closer cooperation.

To avoid the divisiveness and erosion risks, the Commission has a central role in the decision to create and enlarge any enhanced cooperation (see Box 4.1). This is smart. The Commission raison d'être would be threatened by ECAs that endangered the *acquis* or created a core-periphery structure among members. It has a clear incentive, therefore, to ensure that only appropriate ECAs go ahead and that they remain open.

BOX 4.1 Rules for starting, operating and enlarging ECAs

To start a new first-pillar ECA, members ask the Commission to make a proposal. The Commission can refuse, thus killing the initiative, but if it makes a proposal, the Council must approve by qualified majority (a member can refer it to the European Council for discussion, but after discussion QMV is still the rule). In areas where the co-decision process applies, Parliament must approve it (by absolute majority). For third-pillar areas (home and justice affairs) the initiation procedure is similar to that of first-pillar ECAs in that members have no veto and eight is the minimum number of members, but neither Parliament nor the Commission can veto. Specifically, although the first request must go to the Commission and the Commission can then formulate the exact proposition, the Commission cannot stop the project since if the Commission refuses to propose, the members states (minimum of eight) can put forward their own proposal. Starting an ECA in second-pillar areas (security) is now possible, except in areas that have military implications or which affect defence matters. However, these face a *de facto* veto by any member, the 'emergency brake', since normally only QMV authorization by the Council is necessary but any member can demand a unanimous decision in the European Council.

On enlarging ECAs, the basic principle is that any willing and able member can join at any time. The Commission decides who joins for first-pillar ECAs, but for second-pillar ECAs the Council decides after the Commission has given its opinion (entrance is granted by the Council unless a qualified majority opposes); however, here again the emergency brake applies. Third-pillar ECAs follow the same procedure, but only current members of the ECA are allowed to vote or to exercise the *de facto* veto.

Methods for adopting acts necessary to implement an ECA follow the procedures laid down in the Treaty articles concerning the relevant area. As far as the Council is concerned, nations who are not active in the ECA cannot vote on these decisions (under either QMV or unanimity). By contrast all Commissioners and MEPs participate as usual, including those from nations who are not active in the relevant ECA.

Specifically, the Commission can veto ECAs covering deeper economic integration (i.e. first-pillar areas) and it controls subsequent membership enlargements of these. In other areas, the Commission has a strong voice in the process of setting up and expanding ECAs, but less so in the security-and-foreign policy area (second pillar) than in home-and-justice areas (third pillar). It can also be the administrator of such groups. This Commission power is more important than the introduction of QMV in the Council on the matter of enhanced cooperations – at least from the point of view of avoiding the possibility that the EU embarks on the erosive path of Europe à la Carte or the divisive path of variable geometry.

Making flexible integration too difficult, however, is as bad as making it too easy. The Schengen Agreement shows that subgroups of EU members will proceed with deeper integration efforts outside of the EU mechanism, if it is too difficult to proceed within the EU's structure. Such purely intergovernmental initiatives, however, threaten the cohesion and relevance of the EU. Recognizing these facts, the Amsterdam Treaty 'regularized' flexible integration in the form of 'closer cooperation', but constrained its use by granting each EU member a *de facto* veto over the initiation of new closer cooperations (see Box 2.3, on p. 13). Unanimity in the EU15 is hard; unanimity in the EU27 will be vastly more difficult, especially since some newcomers may be tempted to extract extra 'solidarity' funds in exchange for allowing any deeper integration that leaves them out. Thus if the *de facto* unanimity rules had remained, setting up new closer cooperations arrangements might have been *de facto* impossible after enlargement. The Nice Treaty goes a long way towards making sure that intergovernmental cooperation on deeper integration takes place within the EU context rather than beside it, by eliminating the veto and allowing second-pillar cooperations, except as regards defence.

Having looked at what EU leaders actually did, next we analyse the likely impact of this on the course of European integration. We argue that this may prove an important new engine for the Euro-integration train.

4.3 Enhanced cooperation and snowballing integration

Enhanced cooperation procedures will make it easier for members of subgroups to integrate with each other more deeply or more broadly compared with the depth and breadth of integration that will be achieved for the EU as a whole. What effect this will have on European integration? This section provides a simple framework for thinking about this; here we draw on the work of Kölliker (2000).

4.3.1 The dynamics of integration politics

What determines whether a nation is for or against a particular integration initiative? This, of course, is a difficult question, but with some abstraction we can make progress.

Whatever the details of the domestic political process, the national government will have to decide whether the net economic benefits of another integration step outweigh the political costs (loss of sovereignty, etc.). The politi-

cal costs, i.e. political resistance, depend largely on the nation's intrinsic stance towards deeper European integration. The citizens of some nations, Belgians for example, are quite happy to pool their sovereignty; others, Swedes for example, are extremely reluctant to do so.

The determinants of the net economic benefits are a complex matter but two principles generally apply. First, the additional gain from an extra integration step tends to get smaller as the integration gets deeper. This phenomenon – called diminishing returns in economics jargon – is due largely to the fact that over its five-decade existence political leaders went for the big gains first.[5] Second, the extra gain from an extra integration step increases with the size of the integrating area. Here is a heuristic explanation of this phenomenon. Removing barriers between the domestic and foreign economies broadens the choices facing firms and consumers and they respond by arranging production and consumption more efficiently. Roughly speaking, the extent to which efficiency is boosted depends upon the extent to which the range of choices is broadened and this typically expands with the size of the integrating area. For example, deeper integration between a small home nation and a small partner will typically yield only modest gains, while integration between a small home nation and a very large economy will yield big gains to the small nation.

Next, to keep things simple, we abstract from the economic differences among EU members. Specifically, suppose that the net economic benefit falls as the level of integration rises in the same way for all EU members. Moreover, suppose members have one of three levels of political resistance to integration: low, medium and high.

With all this in hand, we turn to considering 'snowballing integration'.

Consider the attitude of our three types of members (low-, medium- and high-political resistance to integration) towards another step in economic integration. Typically, governments of low-resistance nations will be for the initiative, those of high-resistance nations will be against it. Medium-resistance nations may be for or against it. We consider the case where they are against it. Under a unanimity rule, the integration would be blocked, but under Nice Treaty rules it could proceed as long as eight members were in support, and this is the case that interests us.

Now, when the integration goes ahead, the world learns a lot more about the net economic benefits of this particular form of integration. At least in some cases, the gains will turn out to be higher than expected. If it does, this will have a round-one knock-on effect – the learning effect. That is, medium-resistance members will re-evaluate their stance in the light of real-world evidence. If the upward revision of the benefits is large enough, medium-resisters may decide to join the low-resisters in the enhanced cooperation project. This expansion will have a round-two knock-on effect – the gravitational effect. Since the gains from integration for a newcomer tend to be bigger when the existing integration group is larger, expansion of the enhanced cooperation group will make joining the group look more attractive to outsiders. If this 'gravitational effect' is large enough, even the high-resistance group may join.

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5   There are, however, many counter examples to diminishing returns in the academic literature on regional integration; see Baldwin and Venables (1995).

Plainly this scenario is highly abstract, but it illustrates clearly how 'learning' and 'gravitational' effects might turn enhanced cooperation into an engine of European integration. Much like a snowball rolling down a hill, the formation of an ECA may trigger forces that eventually pull most or all members into the deeper integration. Of course, if the low-resisters find that the integration provides lower benefits than expected, the snowball will not start rolling and the low-resisters themselves may chose to abandon the project.

4.3.2 Two examples: Schengen and ERM

An example of enhanced cooperation that produces gravity effects can be found in the area of immigration policies. In 1985 five EU members decided to proceed with the removal of internal border controls via the Schengen Agreement (see Box 4.2 for details). To counter-balance the removal of border checks, Schengen initiated closer police cooperation including adoption of a common visa and a computer-aided system for exchanging data on wanted persons and stolen property (the Schengen Information System, SIS). Many other nations have joined Schengen since 1985. Reasons for this enlargement are manifold, but among them is the fact that access to the SIS has proved valuable, and the value of access to the system grows with Schengen membership. Indeed, even Switzerland has shown an interest in joining as a means of enhancing its internal security.

Snowballing integration also occurred in the monetary area. In the early 1980s the European exchange rate agreement (ERM) was limited to a subgroup of EU members. Over time the group expanded to include almost all member states. Part of the argument for joining was that currencies outside the ERM were more vulnerable to speculative attacks since they did not have access to the bilateral intervention mechanism designed to support an ERM member when it reached the lower bound of the fluctuation band.

BOX 4.2 The Schengen Agreement

Signed in 1985 in the village of Schengen in Luxembourg, this was initially an intergovernmental deal (outside EU jurisdiction) aimed at removing immigration controls at internal borders between five EU nations (Germany, France and the Benelux countries). The agreement, intended to take effect on 1 January 1993, was delayed for political and technical reasons and went into effect in March 1995. The five founder states were joined by Greece, Italy, Austria, Spain and Portugal, with Denmark, Finland and Sweden signing up in 1996 when non-EU Iceland and Norway signed cooperation pacts in order to preserve the 40-year-old Nordic Passport Union. Those two non-EU countries participate fully in the Schengen implementation but have no voting rights.

   From the beginning, abolition of border controls was to be accompanied by compensatory measures to avoid security risks. Thus Schengen includes supporting measures such as the mutual recognition of visas, police cooperation, the treatment of applications for asylum, mutual support of police forces, and

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establishment of a computer-aided system for the exchange of data on wanted persons or stolen property (the 'Schengen Information System'). Also, subject to strict conditions, police are allowed to pursue escaping criminals across Schengen borders. Common solutions have also been found by the Schengen states for certain questions concerning firearms and drugs policy.

4.4 Bottom line

European integration has, to date, been primarily driven by the legislative route (the Commission proposes, the Council disposes, the Parliament advises and the Court rules). This was a messy and inelegant approach but it served to advance European integration to levels that the world has never seen among sovereign nations. Given that Council decision-making efficiency underpins the Community Method and the blow that this efficiency suffered from the Treaty of Nice, it seems unlikely that further integration in the enlarged EU will not proceed as before. This leads us to conjecture that ECAs may start a new integration dynamo – one that is equally messy and inelegant, but perhaps better suited to an EU of 30+ members.

The next chapter takes a broad look at how Nice's impact on efficiency and enhanced cooperation may shift the balance of power among EU institutions.

5 The Institutional Balance of Power

At the conclusion of the summit, French President Jacques Chirac claimed: 'This summit of Nice will go down in European history as a summit that shaped the Union'. This is probably correct, but perhaps not in the way he intended.

As argued above, efficiency of the enlarged Council's decision-making process will decrease dramatically under the Nice reforms. This chapter argues that this in turn will change the balance of power among EU institutions. The basic point is that since legislating in the post-Nice, post-enlargement EU will be very difficult, much less legislating will get done. Those institutions that rely on the flow of legislation for their power will, correspondingly, find their power *de facto* restricted. There may also be secondary shifts in power concerning the little legislation that does make it through the process, but these effects are probably secondary to the impact of the reduced flow of new directives and regulations.

The institutional balance of power is an elusive concept, so we begin this chapter with a framework for thinking about the power balance.

5.1 Thinking about institutional power: a framework

This section presents a framework that we find helpful in organizing our thinking about how the Treaty of Nice may shift the balance of power among the EU's four key institutions – the Council of Ministers, the European Commission, the European Parliament and the European Court of Justice.[1] These bodies do three things:

1. adopt legislation;
2. administer and implement the legislation; and
3. adjudicate disputes concerning the application of legislation, and settle inconsistencies among various bits of legislation.

We begin with point one.

5.1.1 The power of agenda setting

Legislating in the EU is now a complex process. To present the basic issues with a minimum of clutter, we start simple and add in complexities progressively. Thus, consider the process as it was before the Single European Act, i.e. when the Council was the legislative body and the Commission was the agenda-setter; the

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1 This section is greatly inspired by the ideas of Garrett and Tsebelis (2000, 2001).

Parliament merely advised. The key element to explore here is the power of agenda setting and how changes in decision-making efficiency affect it.

If the Commission is smart, and it usually is, it thinks ahead and only puts forward proposals that the Council will accept. This constrains what it can propose, but only partially since on many issues, a whole range of proposals would be acceptable to the Council and herein lies the Commission's power. Since the Commission determines what is put before the Council, the Commission gets to choose its favourite among all the passable proposals and can thus directly influence the shape of the final legislation.

How much influence? The answer depends upon how easy it is to get a proposal accepted by the Council. Here is the logic. Generally speaking, the easier it is to pass a proposal in the Council, the wider is the range of passable proposals. The wider is the range of passable proposals, the more influence the Commission has (a wider range means greater leeway in shaping the resulting legislation). For instance, when the EU had only six members, a qualified majority required consent of only three nations, so a passable proposal had only to please three members. When the same six decided by unanimity, a passable proposal had to please six members. Plainly, the range of passable proposals on any given issue would be wider under QMV than under unanimity. Thus the Commission has more power/influence on issues decided by QMV than on those decided by unanimity. More generally, we can measure ease-of-passage – and thus indirectly the width of the range of passable propositions – using the passage probability described in Chapter 3. Following the logic in this simplified legislative process, we see that the higher is the passage probability, the stronger is the Commission's agenda-setting power, and thus the more powerful is the Commission relative to the Council.

There is a refinement to be added here. The relative power of the Commission versus the Council is also influenced by the extent to which members think alike. For example in the extreme, and extremely unlikely case, that all members are of one mind on a particular issue, the Commission will have little leeway. Pleasing one member is the same as pleasing them all. Extending this logic we see that the range of passable proposals tends to widen as members' preferences become more diverse. This widens the scope of issues that the Commission can use to win the requisite votes in the Council. In short, the agenda-setter's power tends to increase as the membership becomes more diverse.

These points are illustrated with a numerical example in Box 5.1.

BOX 5.1 Commission–Council power balance: a numerical example

Consider a simplified Council of Ministers operating with a 51% majority rule and only two EU members (France and Italy), each with 50 votes. Furthermore, suppose that there are only three possible integration 'parcels' (A, B and C) under discussion. Table 5.1 below shows the preferences of the members over the three parcels with a positive number indicating the member's strength of support and a negative number indicating its strength of opposition. For instance, the +3 shows

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that France strongly supports issue A. The –1 at the bottom of the first column shows that France opposes issue C. Importantly, we suppose that the support/opposition indicators can be added, in the sense that France's stance on a package of issue A and issue B is +4, *viz.* 3 plus 1.

Table 5.1

Issues	France	Italy
A	+3	–2
B	+1	–2
C	–1	+3

Inspection of Table 5.1 shows that no issue on its own would win (in our simple example, 51% requires both nations to agree). It is possible, however, to pass some of the issues via 'packaging'. In particular the package of A and C would pass since France likes it on net (i.e. +3 – 1 is positive) and Italy likes it on net (i.e. –2 + 3 is positive). The other possible combinations, namely A&B, B&C and A&B&C, would not pass.

Since only one combination of issues will pass in this example, the Commission has little leeway and therefore little influence/power. For example if the Commission likes C, but dislikes A, its only options are to get A and C passed together, or to have neither passed by proposing nothing. Now consider an increase in decision-making efficiency in this Council.

Suppose Council decision-making is made easier by lowering the majority threshold to 50% (i.e. passage requires only one nation's vote). Looking at Table 5.1 with this new majority threshold in mind reveals a large increase in the Commission's power. Indeed, now any issue proposed will pass, so the Commission could get its preferred issue C passed without having to accept A, which it dislikes. This illustrates how decision-making difficulty in the Council reduces the scope for the Commission to impose its preferences.

Next consider the link between Commission power and the diversity of members' preferences. For simplicity, suppose the old threshold (51%) is maintained, and a new member, Spain, enters with 50 votes and preferences as shown in Table 5.2. Perusal of the new situation shows that the Commission's choice is expanded. Now A&C, A&B and B&C would all attract at least 51% of the votes. Notice the role of preference diversity here – if Spain had the same preferences as France, the Commission could get A or B separately, if it so wished.

Table 5.2

Issues	France	Italy	Spain
A	+3	–2	+3
B	+1	–2	+2
C	–1	+3	–1

Of course, this is just a simple numerical example, and one can cook up examples that provide other results.

This presentation has focused on a single round of Commission–Council interaction. While it illustrates the main source of an agenda-setter's power and the impact of efficiency on it, it misses the way in which the agenda-setter can, over time, have a much larger impact. This point is amplified in Box 5.2.

BOX 5.2 Agenda-setter and sequential play

This point can be seen most easily in the context of a simple but artificial example. Suppose the voting is all about the division of a cake, and each member of the Council as well as the Commission itself, would like to have as much of the cake as possible. To keep things simple, suppose the majority threshold is 50%+ with each Minister having one vote. In the first round, the agenda-setter puts forward the following proposal for a vote: half of the cake will be divided among nations 1 to 8, with the rest getting none; the Commission keeps half the cake for itself. On a take-it-or-leave-it basis, this proposal would be approved (nations 1 to 8 would vote 'yes' and 9 to 15 'no'). In the second round, the agenda-setter proposes to take away the cake of nations 1 to 7, promising a few crumbs to nations 8 to 15, but keeping most of it for itself. Now again on a take-it-or-leave-it basis, this proposal would be adopted by a vote of 8 yes's and 7 no's, since the proposal improves the situation for 8 out of 15 nations. Now this is a quite artificial example, but it does illustrate two points. First, it is a bad idea to grant agenda-setting power to someone you do not trust and this may suggests why nations are so keen to having a Commissioner. Second, it suggests that the switch from unanimity (where this sort of subterfuge does not work) to QMV may have very large effects on outcomes.

5.1.2 Adding in the European Parliament

Since the Maastricht and Amsterdam Treaties, the European Parliament plays a large role in EU legislation. Again we start simple, to keep issues distinct.

A simple starter: the assent procedure
Under one of the EU's legislative procedures (the 'assent' procedure, see Box 5.3), the Parliament has an up-or-down vote on Commission proposals. Here there is a clear agenda-setter (the Commission) and two deciding bodies (the Council and Parliament). The balance of power between the agenda-setter and the deciding bodies follows the logic described above; anything that decreases the passage probability in the Council or in the Parliament lowers the Commission's power *vis-à-vis* the deciding bodies.

The Council vs. Parliament power balance is governed by a similar principle to the Commission–Council interaction discussed above. The threat of a parliamentary veto influences the shape of the final legislation since it constrains the range of passable packages. The threat of veto, however, has less effect as the range of passable proposals in the Council narrows. The point is that the Parliament, like the Commission, can use its veto power to alter the shape of a proposal, but since any altered proposal must also pass the Council, the Parliament's influence is limited to the range of proposals that are passable in the Council. As a result, changes that make Council decision-making less efficient, reduce the Parliament's influence by narrowing the range of Council-passable proposals.

BOX 5.3 Parliament's role in EU legislation

In 1958, the European Parliament (called the 'European Parliamentary Assembly' until 1962) met for the first time with its members appointed by the national Parliaments. Since 1979, Members of the European Parliament (MEPs) are elected by direct universal suffrage and the Parliament's role has increased ever since.

European Parliament's role in EU legislation follows three main procedures depending upon the issue considered. On most issues, the 'co-decision procedure' puts the European Parliament (EP) on an equal footing with the Council. The second procedure, 'consultation' applies to a few areas (e.g. some agricultural regulations). Here the EP is consulted but its opinion carries no legal weight. The third main procedure, 'assent', requires a majority of the EP to approve (without rights of amendment). This applies to a few major legislative proposals where the Council acts unanimously, e.g. the accession of new members. See Appendix 5 for more detail.

We should note here that the effect is symmetric. Anything that makes Parliament's decision-making less efficient would strengthen its hand *vis-à-vis* the Council. The fact is, however, that the Parliament's simple majority rule is radically more efficient than the Council's current QMV rule.

Conciliation Council and agenda-setting confusion

With these basic concepts in hand, we turn to the mainstream EU legislative practice – the co-decision procedure. Under the co-decision procedure, which now covers most proposals, the Commission makes a proposal, which the Council and the Parliament decide on, but – and here is the big change – the Council and Parliament can amend the Commission's original proposal. The details are complex (see Appendix 5), but one way to amend proposals is in the so-called Conciliation Committee. This committee consists of Council, Parliament and Commission representatives who strive to amend the text in a way that can pass the Council (by qualified majority) and the Parliament (by simple majority). The Commission's formal approval is not necessary but the proposal is killed if either Council or Parliament rejects the text.

In this procedure the role of agenda-setter is blurred, and political scientists have not yet converged on a clear characterization of the process.[2] In a few cases, the Commission's proposals have been adopted without amendment, and here the Commission is the sole agenda-setter. In most cases, however, Parliament has proposed amendments and about half of these have ended up as law.[3] When the

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2 See Tsebelis (1994), Steunenberg (1994), Crombez (1997), Crombez (2000), Steunenberg and Dimitrova (1999) and Steunenberg (2000).

3 According to a study of the 82 co-decision procedures completed from 1994 to mid-1997, 'the Parliament proposed no amendments in eight cases. In 24 cases, the Parliament proposed no second-reading amendments, and the measure was adopted on the basis of the common position. In 22 cases, the Parliament proposed amendments at first and second readings, and the Council accepted all second-reading amendments. Only in 28 cases (34% of the total) was recourse to the full conciliation procedure necessary. In one case (application of Open Network Provision to voice telephony) no agreement could be reached, and the proposal was deemed not to have been adopted (19 July 1994). The Commission submitted a new proposal, which was later adopted.' *Source*: web site of EPP Group of the European Parliament based on research in European Parliament, 1998 http://epp-ed-europarl.eu.int/.

process leads to a Conciliation Committee, the proposal can be completely redrafted by the Council and Parliament representatives without the Commission having a veto. In these cases, the Council – being led by the nation holding the rotation EU Presidency – and the Parliament are co-setters of the agenda; the role of the Commission is greatly reduced (although even here the Commission's first mover advantage probably matters).

What should we make of all this?

- If the Commission were sufficiently well informed on Parliament's views and sufficiently far-sighted, it could put forward only those propositions that would be approved without amendment. In this case, the above logic which links efficiency and agenda-setting power would apply. One should note, however, that data on the first years of the co-decision procedure (1994–7) reveals that Commission proposals were adopted, unmodified, in only 8 out of 82 procedures (European Parliament, 1998).
- Given that the agenda-setting role has been blurred, the impact of reduced efficiency becomes unpredictable. Who knows, if agreement is extremely difficult in the Council, the Council and Parliament might both prefer that everything end up on a Conciliation Committee where they can directly hash out an agreement among themselves. Or maybe the member state holding the Presidency would start to play an even larger agenda-setting role.
- Whoever the agenda-setter is, reduced Council efficiency reduces the range of passable proposals and thus reduces the agenda-setter's influence.
- Shrinking Council efficiency reduces the flow of legislation passed and so reduces the influence of all bodies involved; at the extreme of gridlock, relative power is unimportant since it gets exercised on nothing.

Legislation, however, is not the only means of influence in the EU. When Council decision-making efficiency drops sufficiently low – as it did in the 1970s – efforts to advance European integration via legislation are stymied, but integration may advance via other channels. This is our next topic.

5.1.3 Commission and Court vs. Council and Parliament

The Treaties allow for two ways of making EU policy outside of the legislative route – the implementation of existing legislation and the application of judicial decisions. Due to these possibilities, the European Court of Justice (ECJ) (via judicial review) and the Commission (via administrative implementation and enforcement of existing legislation) can have some policy-making power that is independent of the Council and Parliament. These powers have been used to different extents in the past. Now, we consider when such powers become important.

The Court's and Commission's non-legislative power
When it is relatively easy to pass legislation, the Commission tends to pursue its integration initiatives via the legislative route. When the legislative route is very difficult, however, the Commission and/or Court may take up the integration baton directly using their administrative and judicial powers.

A natural question at this point is why the Court and Commission have a major influence over policy when their powers are limited to interpreting existing EU law and settling disputes? The answer has two parts. First, the Treaties

have the force of law in all member nations, and the Court is the ultimate interpreter of the Treaties. Second, the EU's founders put some quite deep notions of integration into the Treaty of Rome (see Box 5.4), and although various EU governments subsequently tried to ignore or delay such integration (especially in the 1970s), the European Court of Justice (ECJ) and Commission can – and, on occasion, have – enforced the original ambitions written into the Treaty of Rome. A prime example can be found in the internal-market field.

BOX 5.4 Radical integration in the Treaty of Rome

The EU's architects had radical goals in mind when they wrote the Treaty of Rome. The Treaty's main architect, Jean Monnet, headed an influential group bluntly called the Action Committee for the United States of Europe and economic integration was the founders' announced means of achieving this lofty goal. The idea was to fuse the six national economies into a unified economic area where firms, consumers, capital owners and workers faced no discrimination on the basis of nationality.

  Articles 2 and 3 of the Treaty set out the main initiatives. Articles 3a and 3b create the customs union by removing tariffs, quotas and 'all other measures having equivalent effect' on trade among members and establishing a 'common commercial policy towards third countries'. Article 3c creates a common market by requiring 'the abolition, as between member states, of obstacles to freedom of movement for persons, services and capital'. The basic principles of labour and capital mobility are elaborated in subsequent articles. The freedom of movement for workers means the elimination of any form of discrimination based on nationality regarding hiring, firing, pay and work conditions (articles 48–51), and the 1958 Treaty explicitly allows workers to travel freely in search of work. As for capital mobility, the Treaty focuses on two types of freedoms. The first is the right of any Community business organization to set-up in another member state (articles 52–58). The second type concerns financial capital and here the Treaty goes deep. It states (in articles 67–73) that all restrictions on capital flows (e.g. cross-border investments in stocks and bonds, and direct investment in productive assets by multinationals) shall be abolished. It applies the same to current payments related to capital flows (e.g. the payment of interests and repatriation of profits). A big loophole, however, was inserted since capital market restrictions were allowed when capital movements create disturbances in the functioning of a member state's capital market.

  The Treaty of Rome also called for the institution of a system ensuring that competition in the common market is undistorted (articles 3f and 3h). The general principles are fleshed out in a series of articles that:

1. prohibit most forms of 'state aids' to producers (article 92) although a list of exceptions, including aid to poor regions, is specified;
2. create a common competition policy (article 85, 86) and explicitly outlaw price-fixing agreements, controls on production, marketing, R&D or investment, and allocation of exclusive territories to firms in order to reduce

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(Box 5.4 continued)

> competition; the Treaty also requires government monopolies to be of a commercial character to avoid discrimination based on the nationality of suppliers or customers;
> 3. harmonize national laws that affect the operation of the common market; and
> 4. bring some harmonization of national taxes.
>
> By today's standards most of this 1958 agreement sounds radical if taken literally, which is something that the ECJ has the right to do.

The incompletion of the internal market

The Treaty of Rome mandates elimination of all obstacles to intra-Community trade, including tariffs and quotas and 'all other measures having equivalent effect'. Tariffs and quotas were gone by 1968, but the deeper integration was stalled by the Council's unanimity rule. For example, the removal of technical barriers to trade (differences in national product standards and regulations that inhibit trade) began via the legislative route in the late 1960s with a Commission–Council plan (the 'General Programme') which consisted of a detailed timetable for a large number of harmonizing directives on industrial and food products, a standstill agreement on national adoption of new standards and regulations concerning covered products, and an agreement to notify the Commission of new measures adopted for other products.

This so-called 'old approach' failed completely. The timetable, standstill and information agreements were roundly ignored and harmonization proceeded more slowly than the adoption of new trade-inhibiting standards by EU members. For example, 10 years were required to adopt a harmonizing directive on gas containers made of unalloyed steel and 9.5 years was the average delay for the 15 directives adopted *en masse* in 1984. In the meantime, members had, in practice, full discretion to adopt new national regulations as long as they did not cross specific EU case law. Moreover, the Commission received an average of only 11 notifications annually between 1975 and 1982 (Pelkmans, 1989, p.109) while thousands of new regulations sprang up in member states (Majone, 1994, p. 166).

Commission and ECJ to the rescue

Faced with this legislative paralysis, the Commission – which is obliged to ensure the Treaties are implemented – stated in 1969 that product regulations could have equivalent effect to quotas and were thus prohibited by the Treaty of Rome's article 30 which states that 'quantitative restrictions on imports and *all measures having equivalent effect* shall, without prejudice, be prohibited between the member states'. In its 1974 Dassonville decision, the EU Court (whose authority on internal-market matters is supreme) broadened further the scope of prohibitions by opining that 'all trading rules enacted by member states which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an equivalent effect to quantitative restrictions' and are, therefore, prohibited. The Court's 1979 'Cassis de Dijon' case allowed for some trade-inhibiting national regulations and

standards in special cases, but the upshot of these rulings (and a knock-on Commission Directive interpreting the Cassis de Dijon case) was to make 'mutual recognition' the standard operating procedure; after this, one presumed that any product lawfully made or sold in one member state could be sold in any other without further control. In this way, the Court and Commission side-stepped Council gridlock.

Of course, this did not automatically remove all barriers; each of the thousands of barriers would have to be challenged. It did mean, however, that the Council had completely lost control of the integration/liberalization process. Indeed, the Single European Act, and especially its switch to QMV on internal-market issues, can be seen as an attempt by the Council to regain control over the liberalization process.[4]

In addition to the power stemming from its role in the legislative process, the Commission has administrative powers (implementation and surveillance). For example, the Commission is charged with implementing EU legislation and this entails some power in shaping the finer points of policy. Of course, the extent of this power is limited by the amount of existing legislation, so this aspect of the Commission's power has grown with the size of the *acquis communautaire*.

We now turn to applying the framework described above to evaluating the impact of the Treaty of Nice on the EU's institutional balance of power.

5.2 How Nice shifted the institutional power balance

The power-balance impact of the Nice Treaty flows from two features.

1. As shown in Chapter 3, the Nice reforms will sharply curtail the Council's decision-making efficiency.
2. This sharp curtailment of the Council's decision-making efficiency will substantially narrow the range of propositions that can pass the Council and significantly reduce the flow of EU legislation.

Consider the implications.

5.2.1 Parliament's power

The loss of efficiency weakens the power of the European Parliament, or at least one aspect of it, namely the Parliament's power to shape EU legislation. As argued above, the European Parliament's veto allows it to exercise positive power when either its veto-threat forces a modification that is subsequently adopted by the Council, or the anticipation of its veto forces the Commission to modify the original proposal. When only a very narrow range of proposals can win in the Council, the Parliament faces something close to a take-it-or-leave-it proposition. Parliament can still veto the legislation, but this is not a great source of power; propositions that can pass the three QMV criteria are likely to appeal to at least 50% of MEPs on a take-it-or-leave-it basis. After all, the MEPs represent approximately the same constituencies as the Ministers in the Council (of course, the

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4 See Baldwin (2001) for details.

ebb and flow of political parties' popularity implies that the make-up of a
nation's government and its MEP delegation differ).

Parliament's power is reduced in a second, more direct way. The massive
reduction in Council efficiency will surely reduce the flow of legislation. This in
turn makes Parliament less influential since there will be less to influence.

5.2.2 The Council's power

The Council will have greater influence over whatever legislation manages to get
through the very inefficient post-Nice system, but as much less legislation is
expected to pass through, so the Council's total influence is likely to fall overall
even if it rises relative to the Commission and Parliament. As happened in the
1970s, the force of European integration may side-step the Council entirely.

When it comes to integration via new enhanced cooperations, the operating
rules (TEU article 44 in particular) that exclude non-participants from the voting
may well restore Council efficiency. As argued above, this would heighten the
power of the agenda-setter, which may be the Commission. More on this below.

5.2.3 The Commission's power

The Commission's power as agenda-setter in EU legislation will fall since narrowing
the range of passable propositions directly reduces the legislation-shaping power of
the Commission and any other agenda-setter.[5] Its power along other lines, how-
ever, might be strengthen. If the Council gets grid-locked as it did in the 1970s, the
Commission's power to enforce/apply existing legislation administratively may be
improved. The main point here is that the threat of being overturned by the
Council is a constraint on Commission activism, a threat that is dampened with a
Council that finds it extremely difficult to act. Note that in some areas, the
Commission already has administrative and enforcement powers that it chooses
not to use. One example is in the area of 'harmful tax competition'. In principle,
the Treaties grant the Commission the power to act unilaterally against these spe-
cial tax regimes since they are implicit subsidises to particular industries and thus
forbidden 'state aids'. The Commission, however, would prefer to move against
these taxes via legislation, so their actions have the moral force of a Council-
Parliament vote and not just the legal force of the Treaties. Yet if the legislative
route gets shut down, the Commission might use its direct powers more freely.

5.2.4 The Court's power

The Court may also come to the forefront in the face of legislative paralysis, as it
did in the 1970s. While it is difficult to be precise – and impossible to give
specific examples that are likely to arise in the EU27 – the logic of our balance-
of-power framework suggest that the Court may re-emerge as an important
engine of integration in the post-Nice, post-enlargement EU.

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5 Note that the Commission's preferred Council-voting reform, the double simple majority (DSM),
   would have had the opposite effect. According to our calculation in Baldwin et al. (2000), the DSM
   would have sharply increased decision-making efficiency and thus greatly strengthened the power of
   the Commission.

The analysis so far has focused on the legislative approach to integration. Next we consider the impact of enhanced cooperations.

5.3 Enhanced cooperation: implications for the power balance

The Nice Treaty makes it easier to start ECAs and this, together with the sand Nice throws in the gears of the standard legislative machine, suggests that enhanced cooperation may become a major engine of European integration. What does this mean for the balance of power among EU institutions, however?

First, it is a blow to the power of the Council as a body, but a reinforcement of the power of EU member governments who wish to pursue deeper or broader integration. The point here is that the enhanced cooperation mechanism provides a way around the Council's control over European integration. A group of eight or more like-minded members can side-step a blocking coalition in the Council by setting up an enhanced cooperation arrangement (ECA).

Second, when it comes to the balance of institutional power, widespread use of ECAs will act very much like an improvement in Council efficiency. The rules on the operation of ECAs (most of which were set in the Amsterdam Treaty and only slightly modified by the Nice Treaty) create a series of 'mini-Councils', i.e. various Councils of Ministers whose competencies and membership are area-specific. Importantly, decision-making rules inside these mini-Councils are no different than they would be if the full Council were considering legislation in the same area, except non-members of the ECA do not get to vote (TEU article 44). The roles of the Commission and the Parliament are unaffected. Thus from a decision-making point of view, forming an ECA is improving Council efficiency. Formation of an ECA will typically widen the range of passable propositions, enhancing the relative and total power of the ECA agenda-setter, which is likely to be the Commission.[6]

This part of the Treaty is in fact the biggest victory of the Commission in Nice. While the Nice Treaty does not substantially increase the powers of the Commission with respect to enhanced cooperations over those granted it in the Amsterdam Treaty, the Nice Treaty makes ECAs easier to start. This may activate a branch of Commission power that has hereto lain dormant.

This brings to a close Part 1 of our report – the evaluation of the Nice reforms. In Part 2 we consider the reforms that the Nice summit should have addressed but did not.

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6   There is a counter-balancing effect here. The reduction will systematically reduce Council diversity in ECAs made up of like-minded nations. As argued above, less diversity tends to reduce the agenda-setter's power.

Part 2
Nice Leftovers

6 ECB Reform

The European Central Bank (ECB) has a numbers problem.

As argued at length in an earlier CEPR study (Baldwin et al., 2000), enlarging an unreformed ECB to include 5 or 12 new members would turn this critical policy-making body into a big, unwieldy group, opening the door to many awful outcomes. Even in the most optimistic view, ECB decision-making would get much harder. Such difficulties typically favour the *status quo*, so this ECB would have trouble performing a central bank's main task – taking difficult decisions at the right time. The outcome, however, could be worse.

In a scary, but hopefully improbable scenario, one can imagine a Council divided between a dozen or more high-growth-high-inflation 'Irelands' and a handful of 'core' nations. As we show below, the 'Irelands' will have enough votes to set interest rates while accounting for only 20% of the Euro area output.

ECB reform was not on the Nice agenda (see Box 6.1 for an explanation of why), but the urgency and importance of preparing the ECB for enlargement can hardly be exaggerated. The Governing Council will soon set monetary policy for over 400 million Europeans – keeping its decision-making apparatus well oiled should be a top EU priority. Reform is urgent since agreeing the necessary changes will be significantly harder post-enlargement. Moreover, financial markets are forward looking and thus need no more than the *possibility* of a dysfunctional ECB at some future date to react negatively today.

Although EU leaders did not decide the nature of ECB reforms, they recognized the problem and opened the door to a solution by putting an 'enabling clause' in the Nice Treaty. This allows the Bank's decision-making process, which is enshrined in the Maastricht Treaty, to be changed without convening a new intergovernmental conference (IGC) (see Box 6.2 and Appendix 4 for details).

Logic of the chapter's structure

First, this chapter argues that ECB reform is essential. As part of this, we argue that EMU enlargement will come soon after EU enlargement, perhaps as early as mid-2005 if the newcomers join the EU in January 2004. This is based on a close look at the EMU-joining process taking account of all past exceptions. The second element supporting the reform-is-essential postulate is based on an analysis of decision-making in a big unreformed ECB. Here we show that EMU enlargement will disturb the balance of power in the ECB's decision-making body, the Governing Council (GC). Specifically, the Executive Committee now has a dominant role compared to the central bank governors who also sit on the GC, but EMU enlargement would change this. The result, we argue, would be a significantly increased risk of a *status quo* bias in ECB decisions.

The chapter then considers various solutions to the ECB's 'numbers problem'. We begin with some reflection on what the ideal policy-making body would look like, ignoring political constraints. Turning from ideal-ity to reality, we consider the merits and drawbacks of the three conceivable solutions: rotation, representation and executive decisions. Finally, we discuss modalities and suggest that the ECB may find it hard to propose any solution, so the Commission should act. Our recommendation is that the Commission proposes assigning decision-making power to the Executive Board while simultaneously maintaining the accountability of this body by involving non-voting central bank governors in monetary policy discussions.

BOX 6.1 Why ECB reform was not on the Nice agenda

Central bank governors think about the future for a living. Surely they understood that eastern enlargement would require ECB reform. Why, then, was it not on the Nice agenda? The direct answer is that Europe's monetary authorities publicly denied the problem (see below). Perhaps the notion was to prevent reform of the ECB's structure being thrown into the big horse-trading pit of an IGC. Given the way the final deal was handled in Nice, this was probably a wise strategy; it is disturbing to think of what might have happened had ECB reform been on the table at 4 o'clock in the morning on 11 December 2000. ECB reform should be fire-walled from political back-scratching and grandstanding.

Duisenberg vs. Duisenberg on enlargement and ECB reform

President Duisenberg before Nice: 13 April 2000 ECB press conference in Frankfurt:

Question:	Have you also discussed any institutional changes that might be required with respect to the decision-making bodies of the ECB? For example, could you imagine a Governing Council consisting of about 30 members?
Duisenberg:	We have not discussed it today, but we have discussed it many times before. And we do not see the need for institutional changes in the organization of the European System of central banks, including the ECB.

… and Duisenberg after Nice: 5 March 2001 'Monetary Dialogue' with the European Parliament:

Question (MEP Beres):	My second question relates to how the governing board is going to be organized following enlargement.
Duisenberg:	For the Governing Council there might be a problem, that it could become too unwieldy to take effectively decisions were it to consist of say, 25 or 27 members, or it might even reach 30 members in the longer foreseeable future. We are thinking about various models that could be used.

BOX 6.2 What they did at Nice

EU leaders did not ignore ECB reform. They agreed a subtle and wise stratagem. In essence, the Treaty of Nice opens the door to a 'single issue IGC'. This is an important decision. The ECB institutional structure is set in the Treaty on European Union, so changing it would normally entail another IGC – a bad idea for at least two reasons. It might have delayed enlargement, and it would have put the ECB structure into the bubbling cauldron of political trafficking. The Nice solution will, at least to some extent, ensure that ECB reform is considered in a politically uncluttered setting.

Article 5 of the Nice Treaty allows changes to article 10.2 of the ECB statutes, which is the article that specifies the voting rules of the Governing Council. Namely that each Governing Council member has one vote, and decisions are by simple majority with the President breaking ties (see Appendix 4 for the full text). The procedure envisioned in Nice for changing article 10.2 is almost identical to that required for any Treaty change. The Council (meeting at the heads of state and government level) must decide by unanimity, the European Parliament must be consulted, and the change needs to be ratified by all member states. The only difference – but a critical one – is that the 'IGC' that precedes the Council decision only needs to deal with a single issue.

Importantly, the Nice Treaty restricts this process to article 10.2 of the ECB statutes. This may severely limit the set of feasible reforms, excluding perhaps the possibility of handing over monetary policy decisions to the Executive Board. The point is that article 12 of the statutes (see Appendix 4) specifies that the Governing Council as such is responsible for monetary policy decisions. The matter is unclear, however, since article 12 also says 'In addition the Executive Board may have certain powers delegated to it where the Governing Council so decides'.

All this is hair-splitting, however. If the ECB needs to be fixed, it should be fixed properly. There is no reason, for instance, that a new single-issues IGC and a new single-issue Treaty could not go beyond what is currently envisaged in article 5 of

We turn now to demonstrating the need for reform. Readers who are already convinced may skip to our analysis of the reform options and our recommendation in Section 6.2.

6.1 Problems: enlargement and the ECB's 'numbers problem'

When arguing for ECB reform, one of the first responses is that the problem is far into the future. For example, in responding to a question on ECB reform and enlargement, President Duisenberg told the European Parliament, 'Fortunately, we still have some time to go before we come to a decision, or until the heads of state come to a decision on this' (5 March 2001).

This section argues that EMU enlargement will follow fast on the heels of EU enlargement. The basic argument is that the admission decision is ultimately a

political decision and for most of the 12 current EMU members, exceptions were made to the Maastricht rules. Given this, it will be hard to keep out the newcomers, especially since they will have significant power in the Council of Ministers.

6.1.1 EMU enlargement as early as 2005?

Given the strong desire of candidate countries to join the EMU, it seems likely that the monetary union will expand soon after EU enlargement. This section argues that indeed EMU expansion could come very rapidly after enlargement. This sets the stage for the next section that shows how an enlarged but unreformed ECB would malfunction.

The membership timeline

The Treaty lays down a very specific procedure for joining the EMU, which involves meeting specific targets over specific time periods, 'reporting periods'. This is illustrated in Figure 6.1. Once a country has joined the EU it can also join the post-euro exchange rate mechanism (ERM2), and this starts the 'reporting period' clock running. The Treaty specifically requires that compliance with the famous Maastricht criteria – i.e. debt, deficit, interest rates and inflation – be evaluated based on data from the year preceding the evaluation. The reporting period for the fifth main criteria – exchange rate mechanism (ERM) membership without devaluation – is two years, however. What this means is that the evaluation cannot be undertaken until a two-year track record exists.[1] Of course, practice and theory have deviated (as we shall see below) but two years is what the Treaty says, and this means that the convergence evaluation must wait at least until the second accession anniversary.

After the two years have passed, the Commission and ECB need about two months to produce the final data and write their 'Convergence Reports'. These assess the suitability of an EU member state for EMU membership based on compliance with the EMU-related *acquis* and the Maastricht economic convergence criteria. The relevant *acquis* mainly involves central bank independence, capital mobility, and banking and financial stability – things that most newcomers will have under their belts by the time they join the EU. The Maastricht criteria require inflation rates, government deficits and debts, and long-term interest rates to have reached a sufficiently low level, and exchange rates have to have been stable in the report period. The Council of Ministers then deliberates the reports for at least a month.

Putting this all together suggests that the Council vote can come no sooner than 27 months after EU accession. If the answer is 'yes' the EMU-members-elect may need some time to adopt the euro. The founding members took 8 months and Greece took 6, so voting rights in the Governing Council of the ECB should come about 6 months after the Council decision. If the rules are followed to the letter, the process should thus take at least 33 months from the day of EU accession.

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1 Interestingly, revaluation is permissible and was tolerated for Ireland and Greece, although revaluations also indicate that a country has difficulty adjusting to changes in external competitiveness without an exchange rate.

Figure 6.1 Membership to EMU timeline, according to the Treaty

Timeline as in the Treaty

Earliest probable date	Event
1 January 2004	EU accession (voting rights in General Council)
	Reporting period: 2 years 1 year prior to examination for inflation, long-term interest rate, budget and debt; 2 years prior to examination for exchange rate criteria
1 January 2006	
	Data and report writing lag*: 2 months
1 March 2006	Commission and ECB 'Convergence Reports'
1 April 2006	Council of Ministers (Ecofin) votes by 'qualified majority' on Commission proposal
	Changeover period: 6 months
1 October 2006	Voting rights in Governing Council

Notes
* Commission Report on first 11 members came on 25 March 1998 based on data up to March 1998; the Council voted on 2 May 1998; accession to EMU was on 1 January 1999. Commission and ECB Reports on Greece came on 3 May 2000 based on data up to March 2000; the Council accepted in June 2000; accession to EMU was on 1 January 2001.

'To make judgement wholly by the rules is the humour of a scholar', Sir Francis Bacon
The Maastricht Treaty-writers explicitly granted the entry judgement to a political body knowing that political pressure would make for exceptions. Here we look at the exceptions affecting the minimum EU-to-EMU delay.

In 1998, great political pressure mounted to make Italy and Finland founding members of EMU, despite their formal ineligibility. Italy had been in the ERM for only 15 months before the examination and Finland for only 16 months. The Commission and the EMI (the ECB's precursor) more or less coalesced with politicians in overlooking the two-year ERM requirement. This exception was well reasoned and both countries had satisfied the two-year period before EMU's launch, but the exception clearly stretched the Treaty's rules.[2] This set a precedent. Given this, it will be exceedingly difficult to hold a nation like Estonia to a two-year waiting period. Estonia has, after all, been tied to the euro (via its Deutsche mark (DM) currency-board) for longer than Greece. Once an exception is made for one new member state, how likely is it that the others will be denied?

In short, this Italian-Finnish precedent slices nine months off the *de jure* time-

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2 'The criterion on participation in the ERM of the EMS, referred to in the third indent of Article 109j(1) of this Treaty, shall mean that a Member State (MS) has respected the normal fluctuation margins provided for by the ERM of the EMS without severe tension for at least the last two years *before the examination*' (emphasis added). From the *Sixth Protocol of the Treaty on European Union*.

Figure 6.2 Timeline with euro-ization and the Italian ERM period

Earliest probable date		Event
1 January 2004	—	EU accession (voting rights in General Council)
	}	Reporting period: 15 Months* (1 year prior to examination for inflation, long-term interest rate, budget and debt; 15 months prior to examination for ERM criteria)
1 March 2005	—	
	}	Data and report writing lag: 2 months
1 May 2005	—	Commission and ECB 'Convergence Reports'
1 June 2005	—	Council of Ministers (Ecofin) votes by 'qualified majority' on Commission proposal
	}	Changeover period: (0 months for euro-ised nations, 6 months for others)
1 June 2005	↓—	Voting rights in Governing Council

Notes

* Italy's evaluation was based on 15 months of ERM participation, Finland's on 16 months.

line. Euro-ization could take another six months off. Greece passed the convergence test in June 2000, and took up its seat in the ECB six months later. Not all of the applicant nations will face such a delay. With her currency-board peg to the Deutsche mark, Estonia has effectively been using the euro since EMU started and Estonians have seriously contemplated adopting the euro as their national currency once banknotes are issued in January 2002. This would mean no delay, or a very short delay, between the Council's approval and voting rights in the ECB. Other applicants may follow this example.

Note that in a report to the Nice summit, the Ecofin Council of Ministers opined that currency board countries might count as 'an appropriate unilateral commitment within ERM2', but they have strongly warned against unilateral euro-ization ('any unilateral adoption of the single currency by means of "euro-ization" would run counter to the underlying economic reasoning of EMU in the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured convergence process within a multilateral framework. Therefore, unilateral "euro-ization" would not be a way to circumvent the stages foreseen by the Treaty for the adoption of the euro').

All this is fine, but it is just an opinion. And the opinion of the EU15 Ecofin Council is not the one that matters. The actual decisions on EMU participation and exceptions will be taken by the Ecofin Council made up of the 15 incumbents plus any newcomers and here the politics may be very different since – as argued in Chapter 3 – the newcomers will have substantial blocking power in the Council (more on this below). For example, the newcomers in the Ecofin Council could reply that allowing most of the founding members of the EMU in despite their failure to meet the formal Maastricht criteria (see Table 6.2), also runs counter to the underlying economic reasoning of EMU in the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured con-

vergence process within a multilateral framework. The main point here is that once the new entrants have full voting rights, it will be very difficult to treat them differently.

All of this implies a minimum timeline that is 15 months faster than the 33 months suggested in Figure 6.1. The first new EMU members could, therefore, join as early as 1 June 2005, presuming the first EU enlargement happens on 1 January 2004. Of course, possibly only Estonia would be ready then, but given the astonishing Greek effort, it could well be more. Others, such as Gros (2000), estimate July 2006 as the earliest date, but this makes little difference. Whether it is 2005,or 2006, the EMU enlargement train is likely to pull away much sooner than many expect.

How many will be on board?

Some have argued that the newcomers will not be ready for EMU membership for quite sometime, since they will not be able to fulfil the Maastricht convergence criteria. This is wishful thinking.

A glance at the data shows that on the difficult debt and deficit criteria, the frontrunner candidate nations are now better prepared for EMU membership than the current members were at a comparable stage. Taking the first EMU enlargement date as June 2005, there are still four years left before they join. What did the current EMU members look like a comparable number of years before their entry, say in 1994? Figure 6.3 shows the facts for the debt and deficit targets. Except for Germany and Luxembourg, none of the current EMU members met the debt and deficit targets in 1994, and most of the others failed on both standards. The CEECs, by contrast, generally meet both goals already.

Figure 6.3 Then and now: EU15 in 1994 vs. CEECs in 1998
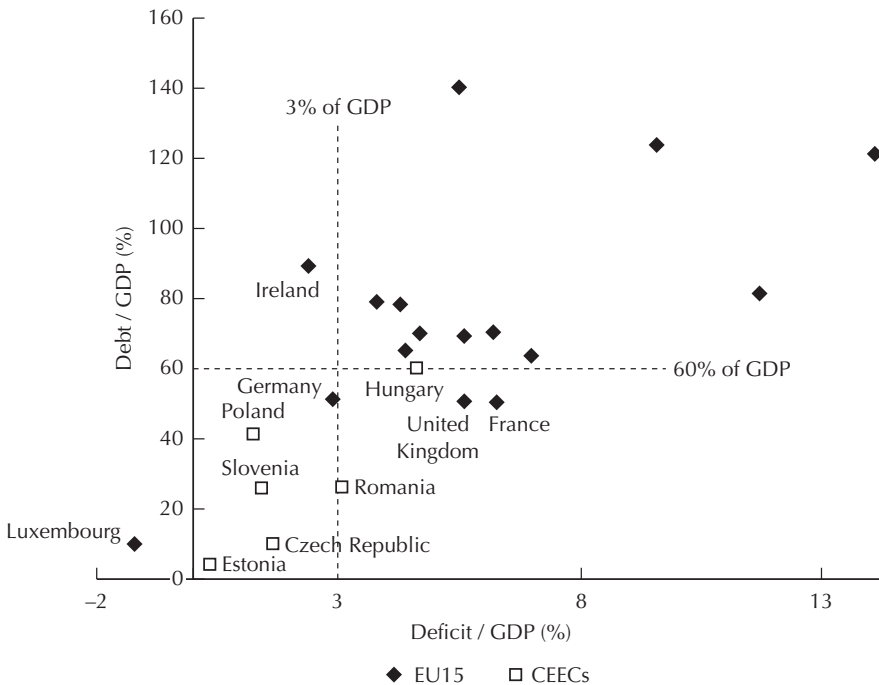
Source: 1994 data, *EMI Annual Report*, 1994; CEEC data from Deutsche Bank Research (2000).

On the exchange rate criterion, the CEECs are again in better shape now than the incumbents were five years before they joined. With the exception of the traditional DM-bloc nations, exchange rates in Europe were a mess in the 1992–4 period. By comparison, the CEECs are doing relatively well, with a few notable exceptions.

The numbers on the inflation and long-term interest rate criteria are reported in Table 6.1. On inflation, Romania is the only country to be in far worse shape than the current EMUers were four years before the start of EMU. In the three Baltic States, inflation is virtually identical to the euro average. For the rest, their 2001 inflation numbers are about twice the current euro average. As for long-term rates, many of the CEECs do not have ten-year government bonds, making the criterion problematic. Remember, however, the Italian and Greek examples: inflation and interest rates can be slashed over a period of, say, two or three years by a sufficiently determined government.

Historical exceptions to the Maastricht criteria

Although the Treaty is quite specific on the five sets of numbers (debt, deficit, inflation, interest rates and exchange rates) political exceptions have been made, as Table 6.2 shows. In the year they were judged ready for EMU, only four of the current EMU members met the debt/GDP threshold of 60%, with Belgium and Italy having more than twice this figure. On the exchange rate criterion, we have already seen that the rules were bent for Italy and Finland. For France and the other wide-band ERM members, the spirit of the Maastricht criteria was violated since 'normal fluctuation' meant one thing to the writers of the Treaty and another thing after the 1992–4 exchange rate crises that avoided a French devaluation or German revaluation by widening the exchange rate bands.

The upshot of all this should be clear. Politics will determine the pace of EMU enlargement. After all, put yourself in the shoes of a Pole, Czech or Estonian who believes, as many in these countries do, that EMU membership is one of the main benefits that will come from EU accession. Wouldn't you read history as suggesting that when it comes to the Maastricht criteria, a political interpretation will be made, and this by a body of which you will be a full voting member?

We turn next to considering what sort of political power the newcomers will have.

Power politics and the convergence judgement

The evaluation duty falls to the Council of Ministers, acting by qualified majority with all member states voting, including those to be judged. How will the vote go? Much depends upon the size and timing of the EU enlargement. When 12 candidate nations are in, they will have 108 Council votes, as Chapter 3 pointed out. This is fewer than they would need to vote themselves unilaterally into EMU (a qualified majority requires 255 votes), but QMV is not the only source of power in the EU.

The EU typically operates in a very gentlemanly manner. In part, this is due to the good will of members, but more concretely, it is because each and every member has the ability to block progress single-handedly on many important issues – things like the budget, Treaty reforms and accession decisions. EU members do not use their veto power in a frivolous manner, but they have often used it to achieve ends that they felt were morally justified, even when this involved

Table 6.1 Inflation and interest convergence criteria, then and now

	Inflation 1994	Long-term interest rate 1994		Inflation 2001	Long-term interest rate 2001	
Belgium	2.4	8.3	Latvia	2.7	8.1	(5-year government bonds)
Denmark	2.0	9.1	Lithuania	2.1	8.5	(7-year government bonds)
Germany	3.0	7.8	Slovakia	6.0	7.9	(government bonds)
Spain	4.7	11.8	Slovenia	5.0	15.1–17.3	(long-term loans)
France	1.6	8.3	Estonia	2.7	10.7	(5–10 year loans)
Ireland	2.4	8.8	Czech Republic	4.1	7.2	(loans > 4 years)
Italy	3.9	12.3	Poland	6.9	10.9	
Luxembourg	2.1	6.2	Hungary	6.5	7.7	(10-year government bonds)
Netherlands	2.7	7.8	Bulgaria	4.5	6.7	(T-bonds)
Portugal	5.2	11.7	Romania	19.4	n.a.	
United Kingdom	2.4	8.9				
EU12	3.1	9.6				
Austria	2.8	7.6				
Finland	3.7	10.1				
Sweden	2.2	10.7				
Greece	5.2	9.8				

Sources: ECB Monthly Report, various issues; IMF, *World Economic Outlook*, October 2000; national central bank websites.

Table 6.2 Historical compliance with the Maastricht criteria

	Inflation (%)	Long-term interest rates (%)	Deficit ratio (%)	Debt/GDP (%)	ERM two-year membership
Austria	1.1	5.6	2.5	66.1	yes
Belgium	1.4	5.7	2.1	122.2	yes
Denmark	1.9	6.2	–0.7	65.1	yes
Finland	1.3	5.9	0.9	55.8	no
France	1.2	5.5	3.0	58.0	yes
Germany	1.4	5.6	2.7	61.3	yes
Greece	5.2	9.8	4.0	108.7	no
Ireland	1.2	6.2	–0.9	66.3	yes
Italy	1.8	6.7	2.7	121.6	no
Luxembourg	1.4	5.6	–1.7	6.7	yes
Netherlands	1.8	5.5	1.4	72.1	yes
Portugal	1.8	6.2	2.5	62.0	yes
Spain	1.8	6.3	2.6	68.8	yes
Sweden	1.9	6.5	0.8	76.6	no
United Kingdom	1.8	7.0	1.9	53.4	no
1998 reference values	2.7	7.8	3.0	60.0	
Greece (2000)	2.0	6.4	1.6	104.4	yes
2000 reference values	2.4	7.2	3.0	60.0	

Source: European Commission Convergence Reports, 1998 and 2000.

severe conflict with other members. The French 'empty chair' policy and Prime Minister Thatcher's trenchant demands for a budget rebate are but two examples. Why should not the newcomers use a veto-threat to get into EMU early?

Imagine that the Estonian, Slovenians, Hungarians, Czechs, Slovaks, Latvians, Lithuanians and Poles all wanted in and had made major domestic sacrifices to make the grade. What could they do if they were refused? One can envisage all sorts of scenarios in 2005 and 2006 when the EU will be working on a new long-term budget plan ('Financial Perspective').[3] According to the timeline in Figure 6.2, this is exactly when the Council will have to vote on EMU enlargement. Is it unreasonable to suggest that the newcomers might implicitly trade their vetoes over the budget to gain EMU membership?

Another scenario involves ECB reform. If the EU fails to reform the ECB before enlargement, the CEECs will have a veto over ECB reform. They might, in this case, feel perfectly justified in threatening to veto reform unless they are assured

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3 The next Financial Perspective covers the period 2007–2013 and discussion on this is likely to take place between 2004 and 2006. (The 2000–2006 Financial Perspective talks started with publication of Agenda 2000 in July 1997 and continued up to the official adoption at the General Affairs Council in June 1999.

that all the exceptions applied the EMU's 12 current members are also applied to them.

The more general point is that if the newcomers feel as strongly about EMU membership as they do now, and they will have made strong efforts to meet the criteria, the political pressure to let them in is likely to be irresistible. As a consequence, one cannot count on a long delay between EU accession and EMU accession.

The unstable ERM2

The sort of exchange rate crises that marked the first ERM would strengthen the argument for early EMU entry. Indeed, asking the new members to join the ERM2 and at the same time to give up capital controls would expose them to speculative attacks. Moreover, anticipating the risk of having to join an ERM2 for two years, many of them may decide to jump into the euro *de facto* by following Estonia and adopting a currency board (see Begg et al., 2001).

Having argued that EMU enlargement is not a distant prospect, we turn to the functioning of an enlarged EMU if no reform is undertaken.

6.1.2 Decision-making in a big unreformed ECB

For the decision-making process in the Governing Council of the ECB to proceed smoothly after a significant enlargement, one of three conditions must be met:

1. all the entering economies are identical to the current Euro area average;
2. all central bank governors care only about the Euro area's average inflation and unemployment; or
3. the newcomers are given GDP-weighted votes.

National central bank governors will inevitably have some degree of national-perspective bias (after all, the governors sit in the Governing Council to bring diverse, real-life experience to the table, something that may be otherwise missing in Frankfurt); the new entrants are very different economically; and the Baltic States are expected to have more ECB votes than Germany and France combined. One can, therefore, predict (as we did in Baldwin et al., 2000) that an enlarged but unreformed ECB will malfunction.

In what follows, we first detail the ways in which the newcomers' economies differ as far as structural inflation is concerned. We then ask whether central bank governors do care about their homelands when voting. Finally, we discuss what all this would mean in an unreformed ECB of 23, 30, 33 members.

Applicant nations are different and this matters

How much macroeconomic diversity would the new members of the EU add to the monetary union? The IMF has recently computed output and inflation correlations for ten central and eastern European countries (CEECs) and Germany, and compared these numbers with the corresponding correlations within EMU. These figures suggest that the newcomers are not too different when it comes to business cycles (as measured by *changes* in inflation and growth rates). Specifically, the growth and inflation correlation between the CEECs and Germany are not dramatically different from their correlation with Poland. The IMF notes that the CEECs currently face somewhat different macro shocks, but

note 'it is hard to predict how exposed these economies will remain to asymmetric shocks by the time they are fully integrated into the EU'.

Business cycles, however, are not the only source of differences over monetary policy. The 12 applicant nations are much poorer and more agricultural than the incumbent 15 and this has long-lived implications for their macroeconomic performance. In particular it means that they are likely to experience higher growth and higher inflation for decades.

Balassa-Samuelson and inflation: a persistent source of conflict

If all goes well, the CEECs will grow two or three times faster than West European nations for decades as they catch up with West European productivity and thus income levels. As it turns out, higher 'non-monetary' inflation is a corollary of this. Here is the argument.

Poorer nations typically have lower price levels than rich nations. Although the prices of traded goods do not vary much from those in rich nations, the prices of non-traded goods, especially construction and labour-intensive services, are typically lower because wages are lower. As productivity, incomes and wages catch up, so do the non-traded goods prices. Given the initial income gap between the average applicant nation and the EU15, this catch up could take two or three decades. During these decades, the newcomers will have higher inflation rates if they attain the higher growth rates necessary to converge.[4] Note that this inflation simply reflects rising living standards. It is very different from inflation driven by too much money chasing too few goods. Paul Samuelson and Bela Balassa first identified the effect, hence the Balassa-Samuelson title. This point is made graphically for the CEECs in Figure 6.4.[5]

What should the ECB do about this?

What should the ECB do about Balassa-Samuelson inflation?

Since Balassa-Samuelson inflation in the new EMU members will be a symptom of growth, the Bank should step back, and simply let relative prices adjust. Euro area inflation would be higher, but this would have nothing to do with output exceeding potential output. This advice does, however, require a slight adjustment of the ECB's self-imposed inflation target of less than 2% to allow for this phenomenon.

To see this, consider a very simple EMU made up of two countries, one rich and one poor, with the rich country's GDP being four times that of the poor one. Furthermore, assume that inflation is zero in the first nation, but – because of Balassa-Samuelson – it is 10% in the second. Using GDP weights, average inflation in this simplified EMU would be 2% (0*0.8 + 10*0.2). Now consider the situation facing the ECB. To keep inflation below 2%, the ECB must do one of two things: force deflation in the rich country via a recession, or force poor-country growth below its long-term potential. Most likely the application of the tools available to the ECB, *viz.* monetary tightening, would lead to some of both. Plainly, neither outcome is desirable and as a consequence, the proper reaction to Balassa-Samuelson inflation is cautious tolerance. The aim should be to keep the GDPs growing in line with their long-run potential and this will inevitably

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4   Gros (2000) suggests that the Balassa-Samuelson effect would lead to an annual structural inflation differential of 3.5–4% for the average CEEC.

5   For another estimate of the Balassa-Samuelson effect in CEECs see Halpern and Wylosz (2001).

Figure 6.4 Structural 'Balassa-Samuelson' inflation in applicant nations

create higher inflation in the faster growing economies. If, say, 1% inflation was the best policy for the Euro area as we know it, something slightly above 1% will be optimal for a Euro area that includes many fast growers. How much higher?

The combined nominal GDP of the 12 new entrants is less than one-twentieth of the Euro area's current nominal GDP. Now if the Balassa-Samuelson effect induced an inflation gap of, say, 5%, the necessary increase in the Euro area inflation target would be 0.1%. Given the current 0–2% target range, the required adjustment would be very small.

Balassa-Samuelson inflation, however, poses a tougher problem – what might be called the 'assignment problem'. As recent experience with Ireland and Spain suggests, it is not straightforward to determine precisely the extent to which inflation is induced by healthy growth and which is induced by an overheating economy. In the first two years of EMU, inflation in Spain and Ireland was, respectively, 1.7% and 2.2% above the EMU average. In Ireland about one-third of this can probably be attributed to higher productivity growth (see CEPR, 2001); in Spain, however, productivity growth has been below the EMU average since the start of EMU, so that excess inflation can only have come from a growth of demand in excess of the economy's potential growth in output, that is from overheating.

Still both countries argued that their excess inflation was structural. This led to a showdown with Ecofin and the ECB who were asking them to tighten fiscal policy to slow down domestic demand. Difficulties of this kind will be common in an enlarged EMU.

Do national governors vote with home conditions in mind?

The ECB was designed to be very independent, but the actual structure is not the most natural to meet this goal. Technocrats would run a completely independent central bank. Instead, the ECB's decision-making body includes members who are politically appointed in their home nations – the central bank governors. Of course, oaths are sworn and decrees are signed stating that the governors are independent experts when sitting on the Council. A Panglossian observer would be satisfied with this; a Machiavellian observer would laugh. The truth is probably somewhere in between.

We do not and cannot know how much the votes of national central bank governors are influenced by economic conditions at home. The ECB does not publish the individual votes of Council members – and there are understandable reasons for not doing this in a body whose members are national representatives. Yet the extent to which individual votes reflect domestic conditions, rather than Euro area averages, matters enormously.

What we can do is look for evidence elsewhere. Some indirect empirical evidence is available from the United States, where the situation is in many respects similar to that of the Euro area. The Fed has a structure comparable to that of the ECB, with a technocratic board and regional representatives. This is an imperfect comparison, of course; the homogeneity of US States suggests that regional representative on the Fed are less likely to have a regional perspective than would European regional representatives.

The evidence, briefly summarized in Box 6.3, is mixed, although some work has identified a home bias in the voting pattern of regional bank Presidents. The lack of clear evidence in favour of a home bias may be the result of the relative

votes attributed to the Presidents of District Banks who are in a minority (5 out of 7). It may also be due to the system of rotating seats, which may affect the voting dynamics; since Board members always win the day, there is no point in regional bank Presidents voting with home conditions in mind. They might disagree with their colleagues from the Board, but it only makes sense to disagree along the dimension on which Board members might disagree, which certainly gives no weight to regional conditions.

The last observation suggests that the relative weight of national governors in the ECB Governing Council may be an important factor in determining the outcome of the vote. Currently they are 12 out of 18. How is the dynamics of voting affected by this particular composition of the Council, and how might it change in an enlarged Council? Before we turn to this issue it is useful to note one piece of evidence on ECB decisions.

The analysis of ECB decisions during the first two years of operation of the Bank, reported in Alesina et al. (2001), suggests that the Council may have pursued an interest-rate policy more attuned to inflationary developments in three countries (France, Germany and Austria) than to those in the Euro area as a whole. During the first few months of EMU (January–March, 1999) monetary policy was somewhat tighter than the needs of Germany and France would have called for. With the April 1999 cut, however, euro interest rates moved closer to those that France and Germany would have chosen if the Banque de France and the Bundesbank still existed and acted independently.

BOX 6.3 Is there a regional bias in the votes cast on the US FOMC?

The Federal Reserve Open Market Committee (FOMC), which sets interest rates in the United States, is composed of 12 voting members: 7 of these are members of the Board of Governors and 5, on a rotating basis, are Presidents of the Federal Reserve District Banks. Among these 5, the NY Fed has a permanent seat, and the Chicago and Cleveland Feds alternate. All Board of Governor governors are political appointees. At the regional level, District Bank Presidents are appointed by a local board (with heavy-handed supervision from the Fed chairman) and the Presidents are guided by their Boards, which are made predominantly of local bankers and business people.

On the issue of regional motives in setting monetary policy, there is ample evidence from a long history of voting on the FOMC. Havrilevsky and Gildea (1995) find that both Board members and Reserve Bank Presidents reflect, in their voting, their political roots and that they are swayed by the prevailing winds. The evidence is based on exploring those frequent instances where there are split decisions and looking on which side of the split a particular member of the FOMC votes. There are differences among governors and bank Presidents. Specifically 'bank Presidents chosen under different Administrations prefer less expansion than governors appointed by the same Administration' (ibid. p. 279).

The evidence on a regional bias in the voting pattern of the Presidents of banks is not decisive. Havrilevsky and Gildea (1992, 1995) conclude that there is, indeed, a decisive regional effect at work, but Tootell (1991, 1997) using a different methodology finds the opposite.

This evidence is consistent with a Governing Council in which the prevailing majority was the result of the six Executive Board members joining the governors from France, Germany and Austria. Why would the six Executive Board members do this? May be it was the best they could achieve, given that France, Germany and Austria account for 60% of the area GDP in the EMU12.

Later, however, as economic conditions in France, Germany and Austria started improving, the ECB did not raise interest rates as fast as an ECB that looked only at these three countries would have done. Thus the evidence of a regional bias is mixed at best.

6.1.3 Voting in an unreformed Governing Council

So far we have established two points: EMU membership is unlikely to be delayed, and the newcomers into the euro will differ from the current group, in particular because they will grow faster and have higher inflation. Assuming that the voting rules in the Governing Council do not change, how would it function with 30 or 33 members?

First we admit that no outsider can know how the procedure for changing interest rates actually works in the Governing Council of the ECB. The ECB Statutes, laid down in the Maastricht Treaty, say that the decision is taken by a simple majority with each central bank governor and each Executive Board member having a single vote. Anecdotal evidence suggests, however, that votes are rarely taken since the ECB seeks to make decisions by consensus. Even if this is so, the formal voting rules matter. After all, if one knows one will be out-voted, it is better to be collegial and join the consensus. More specifically, the idea here is that the participants go through a mental process of 'shadow voting' (even though no vote takes place) and this shadow vote affects the decision in a way that more or less mimics the outcome that a real vote would produce. Moreover, a consensus with 18 members may just be possible, but with more members, the ECB may have to switch to formal voting.

In any case, the Nice Treaty calls for changes in the formal voting rules, so here we analyse the process assuming that these rules do matter. Specifically, we suppose that the ECB President (who chairs the Executive Board and the Council) proposes an interest rate change, and, if the proposition is contentious enough to require a vote, a simple majority of Council members is required to adopt the proposition.[6] The Council currently includes 18 voters – 6 Executive Board members and 12 central bank governors – each with one vote. With this group, the simple majority rule means nine votes are needed for the President's proposal to be adopted (the President decides in the case of a tie).

Executive Board members vs. national governors: the dynamics of Council votes
Supposing that its six members act in unison, the Executive Board currently needs to find only three more votes to get its way. With 12 national governors at the table, it is relatively easy. Enlargement will change this.

Under current Treaty rules, the central bank governor of each new Euro area member gets a vote on the Governing Council. Figure 6.5 considers what decision-making would look like when 5 of the applicants (say Estonia, Hungary,

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6 Unfortunately for our analysis, the precise decision-making details do matter, as shown in von Hagen and Supel (1994) and De Grauwe et al. (1999).

Czech Republic, Slovenia and Poland) are in the monetary union, when all 12 of the applicants are in, and when all 12 applicants plus Denmark, Sweden and the United Kingdom are in. These ECB enlargements imply ECBs of 18, 23, 30 and 33 voters respectively (eventually, the euro will probably also include many more nations as the EU expands beyond the 12 applicants currently in-line, but an ECB of 33 suffices to make our point.). The bars show how many governors would need to join the Executive Board in order to pass any particular interest-rate change.

The message from Figure 6.5 is that enlargement gravely weakens the relative power of the Executive Board. The number of central bank governors that must be lined up almost quadruples from 3 to 11. Even as a share of the governors sitting at the table, enlargement raises the bar, from just 25% in the current ECB 18, to over 40% of them in the ECB33. Plainly, this will make it much harder for the Executive Board to guide monetary policy.

Of course, if the Governing Council attempts to make decisions by unanimity, the problem is much more severe. Getting 12 governors to agree is hard; getting 27 to agree will be very, very hard.

Hypothetical alliances in an enlarged Governing Council

Another way to make this point is to look at hypothetical coalitions that might form in the Council post-enlargement. To do this, however, we need to address the issue of the positions of the Executive Board and the governors on monetary policy. Let us assume that the six Executive Board members only care about Euro

Figure 6.5 Enlargement and the rising difficulty of ECB decision-making
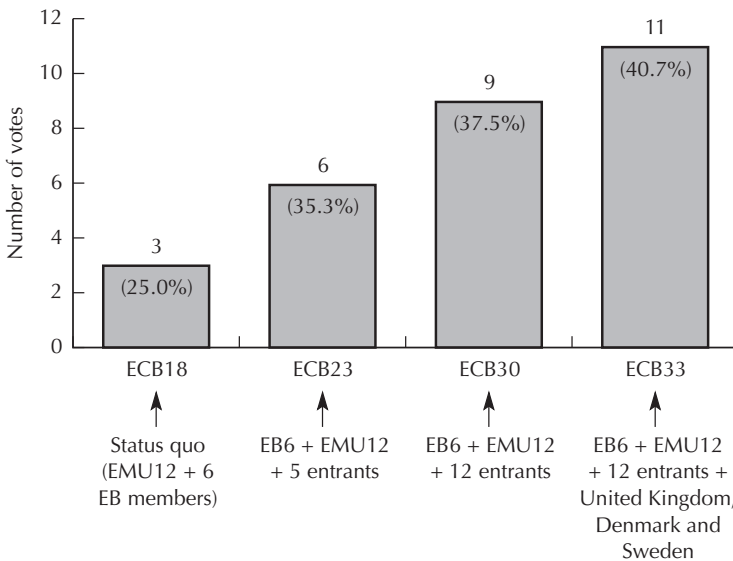
Notes
If the Executive Board acts in unison, how many national central bank governors must join them to form a winning coalition? Figures in parentheses show the number as a share of all CB governors.
EB6= 6 Executive Board members.

Source: Authors' calculations.

area inflation, i.e. that they have no national bias. Euro area inflation is the average of national inflation rates, where the averaging uses weights that are related to the economic size of member nations (here we take GDP weights to be specific). Also, for the sake of argument, let us adopt the extreme Machiavellian view that the central bank governors care only about their national inflation rates.

Now given that a fistful of 'core' nations dominate the EU GDP (France and Germany alone account for more than half of EU GDP), the national inflation rates of these same nations also dominate the Euro area inflation average. What all this means is that the Executive Board will find natural allies among these 'core' economies – even if all governors take purely national perspectives. Under this analysis, Governing Council decision-making is currently relatively smooth because the Euro area average is dominated by six nations whose macro-economies are relatively synchronized.

Again enlargement will change this. The applicant nations are now, and will remain for decades, different from the core nations when it comes to inflation and growth, as Figure 6.4 showed. What this means is that it will be harder for the Executive Board to get its way. The problem is that coalitions of non-core nations may have a blocking majority and thus frustrate the Board's efforts to pursue the Euro area averages.

Figure 6.6 shows the evolution of a blocking coalition made up of the 'less synchronized' nations among EU incumbents and applicants. To be concrete, we consider enlargement in two waves and assume that all 12 entrants want to join,

Figure 6.6 Possible coalitions in the Governing Council

	Executive Board (EB)	EB + Core-7	Total less synchronized
ECB18 (%)	33	72	28
ECB23 (%)	26	57	43
ECB30 (%)	20	43	57
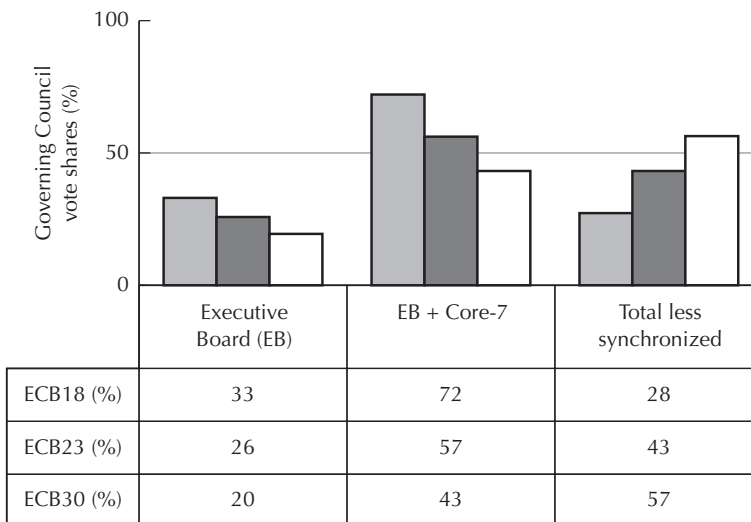
Notes

The last two columns add to 100%.
In each group of bars the 1st bar is the ECB18, 2nd bar is ECB23 and 3rd ECB30.
Core-7 = Austria, Belgium, France, Germany, Italy, Luxembourg, Netherlands.
Less-synchronized = Finland, Greece, Ireland, Portugal, Spain and entrants in ECB23 and 30.

Source: Authors' calculations.

but the United Kingdom, Sweden and Denmark stay out. This gives us the current ECB18 and the future ECB23 (6 Board members plus 12 incumbent governors and 5 governors from the Czech Republic, Estonia, Hungary, Poland and Slovenia), and the ECB30 (the ECB23 plus the other applicants, leaving Turkey aside). Notice that the Board's voting weight shrinks significantly, from one-third to one-fifth, and the coalition of the Board plus the Core-7 (Austria, Benelux, Denmark, France and Italy), shrinks from a dominant 72% to just under the critical 50% mark. The flip-side of this coin is that the total voting weight of the 'less synchronized' economies rises to over a half, enough in theory to dictate Euro area interest rates.

Now, comparing Figures 6.6 and 6.7, we see that the ECB30 would find itself in a very unhappy situation. The 16 less-synchronized nations, who together account for only 20% of the Euro area economy would have enough votes to set monetary policy for the whole area.

Status quo *bias in an enlarged and unreformed ECB*

The simple counting of votes, though very transparent, belies the complexity of ECB decision-making. According to informal accounts, the President, backed by the Executive Board, sets the agenda. This matters a great deal, as anyone who has tried to oppose a chairman knows. To be more specific, we consider an alternate view of the ECB decision process.

We assume that the Euro area's ideal interest rate can be described on an interval that, for conveniences, is normalized to be between zero and one. EMU members' ideal interest rates are uniformly distributed on the interval in the sense that while each nation knows its ideal interest rate at any moment, it also knows that its ideal rate will change in the future. For simplicity, we assume that the members believe that their ideal rate at a randomly chosen time in the future has an equal probability of laying anywhere in the interval. The Executive Board

Figure 6.7 EMU GDP and population shares under current and future membership
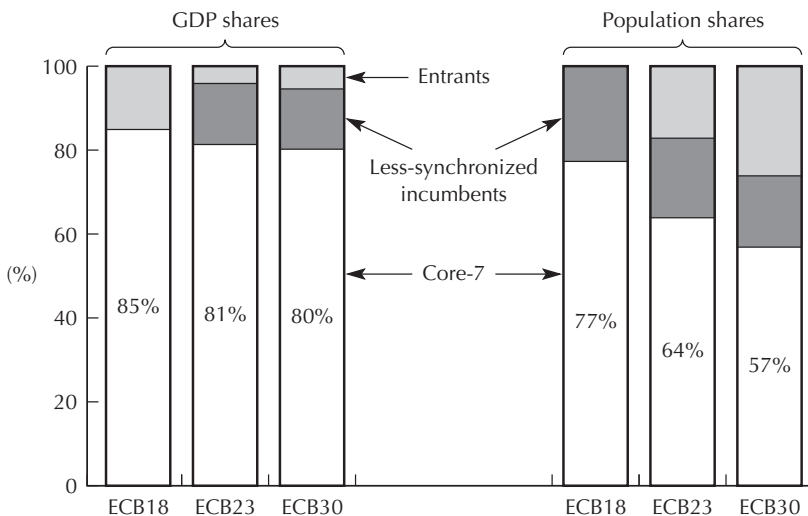
Source: Authors' calculations.

is interested in the Euro area average, so if the EMU members have correctly calculated their ideal rates (and we assume they have), the Executive Board's ideal interest rate is a weighted average of member states' ideal interest rates. Now, a bit of elementary probability theory tells us that since the members' ideal rates are uniformly distributed, the Executive Board's ideal policy is approximately normally distributed with the centre of the distribution on half (this is called the Central Limit Theorem).

Now, we assume the Executive Board makes take-it-or-leave-it interest rate offers to the Governing Council and the Executive Board members all support the proposal. If the Executive Board is smart, and we assume it is, it only proposes a rate change that it thinks will win the vote (i.e. attract a simple majority). The best outcome for the Executive Board is, by assumption, the ideal for the Euro area. If the Executive Board anticipates being unable to win a majority on this, it will propose something that is close to but not equal to this ideal outcome.

This set-up enables us to consider the impact of enlargement on the *status quo* bias. To this end, we first establish what would happen in the case of a completely random macro economic shock that disturbs the initial situation, i.e. where the *status quo* interest rate is at half and this is the ideal rate for the Euro area. Now, suppose that there is a random shock, which shifts the weighted average of ideal interest rates to the right (by symmetry it does not make a difference whether we move to the right or left). The Executive Board controls the agenda, so it would never propose a lowering of the interest rate after such a shock. The key question, therefore, is: 'Can the Executive Board garner enough votes to increase the interest rate towards the new ideal point for the Euro area?' In the current ECB this means that Executive Board needs three central bank governors to support its proposal.

Since the Executive Board needs only three votes, it is quite likely that any sort of macro shock that leads to an increase in the Euro area average will entail national ideal positions such that the Executive Board can find at least three allies for its policy to increase interest rates. To look at this in another way, note that it is extremely unlikely that the ideal (i.e. Euro area weighted average) interest rate has increased, yet 10 out of the 12 central bank governors would prefer the *status quo* to an interest-rate increase. Using actual GDP weights of the EMU12, our simulations for the *status quo* outcome is quite low, about 4%. What this means is that in the current ECB, the *status quo* bias is quite low; the balance of power between the Executive Board and the governors is such that the Euro area ideal rate will typically be pursued, even if the central bank governors vote along purely national lines.

What does EMU enlargement do to the *status quo* bias? In the case of the ECB27 (using current GDP weights), our simulations show that the bias increases enormously, more than four-fold. Although probability of a *status quo* bias is fairly low, our simulations suggest that a big, unreformed ECB would suffer from a *status quo* bias in one-sixth of its decisions – not good news for a central bank whose actions affect the lives of hundreds of millions of Europeans. Figure 6.8 shows the precise results.

Reaction to big asymmetric shocks affecting large members
Another question is how well the ECB27 can react to changes in EMU-wide weighted average if there is a more specific need to react. To consider this question we study three scenarios.

Figure 6.8 How ECB enlargement raises the *status quo* bias in interest rate decisions
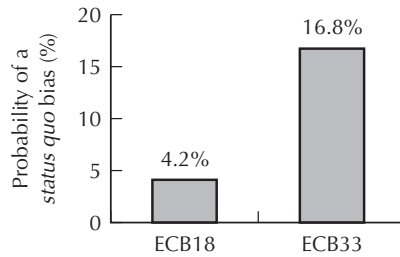
Source: Authors' calculations.

1. It is assumed that France and Germany are hit and their ideal policies jump to location 1, i.e. they need a big interest rate increase.
2. It is assumed that Benelux countries follow the same pattern.
3. That Italy also joins this group.

In all cases, we assume the ideal interest rates for the other EMU members are uniformly distributed on the zero-to-one range. Of course, all three shocks will raise the Euro area weighted average ideal above the initial, *status quo* level of half.

Once more, we calculate what each of these shocks does to the Euro area and Executive Board's ideal interest rate policy; and again we calculate the probability that the Executive Board can win a vote to increase interest rates. To be more specific, however, we consider the probability that the Executive Board would win a vote on increasing the rate all the way to the Euro area ideal, and we consider the probability that it would win a proposal to increase the rate to half way between the *status quo* and the Euro area ideal.

In Figure 6.9 it has been assumed that the Executive Board tries to pass the full policy reaction first in the ECB27. The respective bars of 'Full' give the passage probabilities of this proposal. It can be clearly seen that in the case of such asymmetric shocks, the ECB's capacity to act is quite limited, with the probability of passing an optimal policy in the ECB27 falling below half in all three scenarios. By contrast, the figures for the EMU12 (not shown in the diagram) are quite high, exceeding 95%. The bars showing the passage probabilities for a halfway policy are higher, but the main message of this figure is that the probability of passing an optimal policy in the ECB27 may fall below one half.

Summing up

An enlarged and unreformed ECB would run into severe difficulties that would hinder its ability to take decisions in the Euro area's best interest. Enlargement would weaken the relative power of the Executive Board, the body most likely to vote with Euro area conditions in mind. Enlargement would create the opportunity for coalitions formed by non-core EMU members to win the day, and set interest rates for the whole area. Finally, enlargement might induce a *status quo* bias, making it more difficult to come to a decision.

In short, we have argued that the ECB will have a big 'numbers problem', so ECB reform is imperative. We turn now to considering the form it should take.

Figure 6.9 How the ECB27 would react to a shock in the Euro area's core economies

Passage probability and size of shock

'Full': adopt optimal policy reaction for Euroland average — 31%, 51%, 37%

'Half': adopt rate change halfway between 'full' and *status quo* — 71%, 89%, 90%

☐ France and Germany ☐ France, Germany and Benelux
☐ France, Germany Benelux and Italy
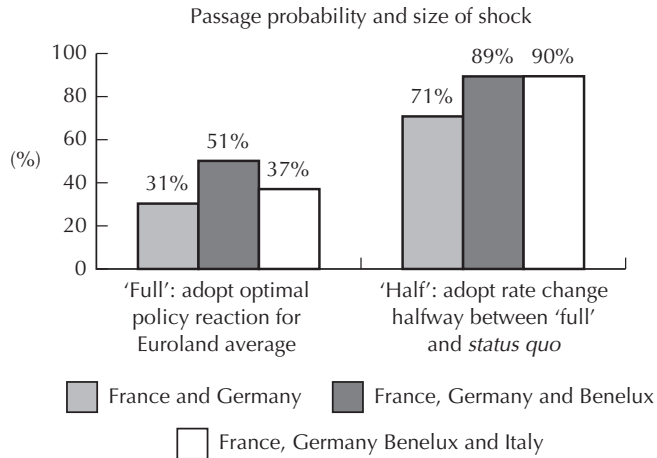
Source: Authors' calculations.

6.2 Solutions: reform options and a recommendation

Politics and national jealousies will play a huge role in determining the ultimate solution to the ECB's 'numbers problem', and we shall address these in turn. We start, however, by considering what would, in our opinion, be the best way to manage Europe's monetary policy in a world without political constraints.

6.2.1 Monetary policy management in the best of all possible worlds

The perfect monetary policy keeps inflation low and stable while simultaneously stabilizing aggregate demand fluctuations – providing monetary stimulus in downturns and monetary restraint in upturns.

This is a tricky business for both economic and political reasons. The economics of it are difficult since the relationships between monetary policy, output and inflation are subject to long and variable lags. One thing is clear, however. A loose monetary policy stimulates output and boosts inflation, but the output boost usually comes sooner than the inflation. It is this fact that makes the politics tricky. A central bank that cares both about unemployment and inflation will try to exploit this short-run/long-run trade-off in an attempt to reduce unemployment. A government may also be tempted to exploit this trade-off to win elections. If a monetary stimulus is timed right, the political benefit of higher output will appear before the election with the political cost of higher inflation appearing only afterwards. Of course investors and workers are aware of these temptations, so the typical results is higher than desired inflation and a lack of central bank credibility.

There is a solution to this quandary and it is now almost universally adopted. Make sure the central bank is: (1) independent of the elected government, and (2) clearly focused on keeping inflation low and stable. Of course this solution poses problems of its own. Legitimacy and democratic accountability are the main ones.

No central bank can operate without the public's trust and here some sort of democratic accountability is essential. Yet, the balance between accountability and independence is a fine one. Ultimately, accountability means that sufficiently poor performance will lead to some sort of sanction. Without this, citizens may suspect that the central bank could drift 'off mission', perhaps pursuing some pet monetary theory or favouring one particular social group. With sanctions, the citizens can rest assured that the central bank will do its job, or else. The problem is that it can be difficult to distinguish between warranted and unwarranted use of such sanctions. Indeed there is no consensus on the best form or means of control of such sanctions. Nations across the world have adopted a wide range of solutions. Nevertheless some implications are clear.

The ideal ECB decision-making body

On our logic, an ideal monetary decision-making body would consist of experienced and highly competent individuals who are primarily concerned with keeping the Euro area's inflation rate low and stable. Competency, not nationality, should be the key qualification (more on this below). This body should have enough members to provide a healthy debate and a robust representation of different points of view, but it should be small enough to make tough decisions quickly. The members should not represent elected governments; they should be independent. Yet they should be democratically accountable in the sense that in the unlikely event of extraordinarily poor performance, they would eventually face some form of sanction.

Going from the ideal to the real is the next topic.

6.2.2 Reform options

Looking ahead at an ECB Council comprising 30+ members, there are essentially three options for keeping the number of decision makers at a reasonable number – all of which involve a reduction in the number of central bank governors who are allowed to vote. The options are:

- rotation,
- representation, or
- executive decisions.

We consider these in turn, keeping the best for last.

Rotation

Rotation means that not every central bank governor would have a right to vote at each meeting. There can be many forms of this. The main parameters are the number of central bank governors with a vote and their tenure as vote-casters.

At one extreme, there could be a few central governors on the Governing Council, say three, with long appointments of, say five years. This would result in a small number of voters on the Governing Council and a highly stable composition. In an EMU with 24 members, however, this would mean that at any one time 21 central banks would be without a vote, and with perfectly even rotation, a typical central bank would have to go 35 years without its governor voting. At the other extreme, there could be many voting central bankers, say 12, with short tenures of, say six months. This would leave only 12 of the 24 central

banks without a vote and no central bank would be without a vote for more than six months. Such a Governing Council, however, would have a membership that varied frequently – not something that boosts credibility and predictability – and with 18 voting members it might be at the limit as far as decision-making expediency is concerned. As Table 6.3 shows, the smaller the number of voting governors is and the longer the vote-casting tenures are, the longer nations will have to go without a vote.

Table 6.3 Rotation in an ECB30, maximum number of years without a vote

Voting-casting term (years)	*Suppose there are 24 central bank governors on the Governing Council. Number of governors casting votes:*			
	3	8	12	24
0.5	3.5	1	0.5	0
1	7	2	1	0
2	14	4	2	0
5	35	10	5	0

Note: Numbers show the maximum number of years without a vote.

Source: Authors' calculations.

Note that non-voting central bank governors could still participate in the discussion preceding a vote, or at least be present during the discussion. Indeed, in the rapid rotation model, it would be essential for all central bankers to stay continually abreast of events and the evolving discussion.

The European Commission's number problem, which has a highly symmetric numbers problem, was 'solved' in Nice with the rotation option (actual decisions on the rotation details were postponed until the 27th member joins, see Chapter 2). The fact that this proved politically acceptable to the European Council in Nice is important since the same EU leaders will decide how to solve the ECB's numbers problem. Moreover in March 2001, ECB President Wim Duisenberg told the European Parliament: 'I think that the rotation model, but now I am speculating, will be the most likely outcome of that discussion [on ECB reform]'. It is important to note, however, that the premise of nationality-based rotation belies the assertion that central bank governors are independent experts, not national representatives.

BOX 6.4 Rotation: real-world example – US Federal Reserve Bank

Partial rotation is the system adopted by the US Federal Reserve Bank (the 'Fed'). There, the body responsible for taking monetary policy decisions, the Federal Open Market Committee, includes the 7 members of the Board of Governors – a body which corresponds to the ECB Executive Board – the President of the New York Fed and, on a rotating basis, 4 out of the remaining 11 Federal Reserve Bank Presidents. The remaining 7 regional Bank Presidents attend the meeting but do not

(Box 6.4 continued)

cast a vote. This system guarantees that the majority always lies with the 7 members of the Board of Governors. As mentioned above, this feature may be crucial in avoiding the possibility of a regional bias in Fed decisions.

One should note that the Fed model is specific to the history and the characteristics of the United States. Unlike the European case, 11 out of the 12 US Federal Reserve Banks are relatively equal in terms of the size and importance of the regions they represent and this makes rotation more palatable. The permanent seat of the New York Fed is justified by the very special role that this Bank has historically occupied in the Fed System. The financial market is disproportionately located in New York and all open market operations are undertaken through the New York Fed.

Representation

Representation reduces the number of central bank governors who can vote by grouping central banks together and giving them only one vote per group. As with rotation, many forms of representation are possible. The main parameters are the number groups and the grouping criteria.

One form of this solution would require the members of each group to constitute a sufficiently large fraction of the Euro area economy. Given the enormously uneven distribution of GDP among the EU27, the five largest Euro area economies (Germany, France, Italy, Spain and Netherlands – whose GDPs each exceed 400 billion euros) could have one vote each, with the remaining seven votes divided among the smaller economies. Using current GDP figures, the Euro area GDP without the Big-5 (assuming Sweden and Denmark join but the United Kingdom does not) divided by 7 is about 400 billion euros, so the typical group should represent approximately this amount of GDP. Alternatively, the groups could have an equal number of members with membership determined on a geographical or other basis. While the GDP-based group might seem to treat small members unfairly, it might actually end up giving them a greater say. For instance, if Slovakia got bundled with Germany, it would be unlikely to ever have much influence on the group's stance, but if it were part of a large group of small Central European members, its voice might on occasion be heard. It is also conceivable to combine representation with rotation. For instance, with 24 EMU members, one could envisage 8 groups of 3 with each group's voting right rotating automatically among the three members of each group. If the vote-casting tenure were one year, each nation would find itself without a direct vote for two years.

One problem with representation is the politically daunting task of deciding on groupings and on the decision-making mechanism within groups.

Executive Boards and monetary policy committees

In this solution, monetary policy is delegated to a group of independent experts chosen for their competency, experience and reliability. The main parameters are the number of voters, the length of their tenure and the form of democratic accountability.

BOX 6.5 Representation: real-world examples – IMF and Bundesbank

Representation is the system used in the IMF Board of Directors. Large countries have their own Director (the United States, Germany, Japan, France and the United Kingdom), while smaller countries form groups with a single Director representing each constituency. Some of these constituencies include, along with smaller countries, a few which are of relatively similar size. One, for instance, includes Belgium, Austria, the Czech Republic, Hungary, Turkey, Slovenia, the Slovak Republic, Belarus and Kazakhstan. The Executive Director for this group rotates between Belgium and Austria. Others are grouped around a relatively larger country responsible for appointing the Executive Director. Such is the case of the group that includes Italy, Greece, Portugal, Albania and Malta.

   This was also the solution adopted for Bundesbank reform after unification. Prior to unification the Bundesbank Council included the 7 members of the Board (Direktorium) and 11 Ländeszentralbanken Presidents. Under the old rules, the addition of 5 new länder would have boosted the Council to 23, which was viewed as being too unwieldy for serious central banking. Moreover, the extra Ländesbank Presidents would have seriously shifted power away from the Board. The relative weight of the Board was 39% of Council votes prior to unification. To maintain it at that level with one vote per Ländesbank, the Board would have had to have 11 members, yielding a Council of 27 – and this was perceived as being clearly too big.

   The solution was to merge the 16 regional banks into 9 and reduce Board members by one as well. The Council now includes the 9 regional Presidents and 6 Board members. This has the merit of roughly maintaining the Board's vote share at 40% and limiting the number of decision-makers to 15.

This is the system adopted in many nations – though, as we have seen, not in Germany with its highly decentralized structure. Under this arrangement, monetary policy is delegated to a board, or a committee, whose composition is unrelated to the regional structure of the country. In some countries monetary policy decisions are delegated to a board that includes only full-time executives of the central bank. Elsewhere, in the United Kingdom for instance, the committee includes both executives and non-executives appointed for fixed terms.[7]

   Leaving aside politics for the moment, this clearly corresponds most closely to the ideal monetary decision-making body we discussed above. It would consist of experienced and competent individuals concerned mainly with keeping the Euro area's inflation rate low and stable. If it had, say, 15 members – 6 in the Executive Board and 9 others – it would be large enough to represent most of the different points of view likely to arise in the Euro area, but be small enough to act decisively when events call for action. The members would not represent elected governments and with non-renewable eight-year terms they would be largely insulated from political pressures.

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7 On the pros and cons of including independent experts on such committees, see Lars Svensson (2001) 'Independent Review of the Operation of Monetary Policy in New Zealand: A Report to the Minister of Finance' available at http://www.iies.su.se/leosven/.

One problem though is that such a Governing Council would lack account-ability (more on this below).

BOX 6.6 Delegation: real-world examples – non-EMU monetary policy committees

Table 6.4 shows the size and composition of the monetary policy committees in two European nations who are not members of EMU (the United Kingdom and Sweden) and three non-European nations (New Zealand, Australia and Canada). With the exception of New Zealand the size of such committees varies between 6 and 9; see Svensson (2001) for a criticism of New Zealand's arrangement. In two cases, the United Kingdom and Australia, the committee includes outside experts. In the UK case, the independent experts are a minority of voters, but in Australia they are in a majority having 6 of the 9 votes. The Australian body also includes a Treasury official.

Table 6.4 Size and composition of monetary policy committees

	Size of the committee	Number of executives	Number of Treasury officials	Number of non-executive independent experts
United Kingdom	9	5	0	4
Sweden	6	6	0	0
New Zealand	1	1	0	0
Australia	9	2	1	6
Canada	7	7	0	0

Source: National central bank web sites.

6.2.3 General problems with representation and rotation

The rotation and representation models appear to have been discussed in the ECB and so far both have come up against strong resistance. As President Duisenberg told the European Parliament (5 March 2001):

> You could use rotation, which is the most likely outcome, but then immediately the ques-tion arises – would it be for any country acceptable not to take part in the decision making on monetary policy for some time? Or do you treat countries differently? These are ques-tions which are very sensitive … Another model would be for example to form constituencies to group countries together, but then you would violate the principle of total independence of the individual participants, because a representative of a con-stituency would have to defend the interests of his constituency in the governing council. That would run counter to the total personal independence as it is presently formulated and experienced.

In fact, there seems to be a logical contradiction to the objections President Duisenberg alluded to. Any objection to losing a vote on the Governing Council is a testimony to the lack of independence of the central bank governors. If, for

example, the Spanish governor is absolutely 100% independent of Spain, Spain loses nothing by not having their governor on the Council.[8] Or does she?

Is it possible that the governors are completely independent and yet still serve a national role? The answer is yes. Under current rules the central bank governors serve one explicit and one implicit role.

1. They are independent monetary experts, according to the law, who know a lot about the nation whose central bank they serve.
2. They are the 'ears' of their nation in this closed but hugely important decision-making body.

That is, the central bank governors are important, not only for their monetary expertise, but also since they are the Governing Council's only significant democratic accountability. Central bank governors are political appointees in each and every member state – since this appointment process is a key element of democratic accountability. Of course, under the terms of the Maastricht Treaty their advice on monetary policy must be insulated from national daily politics, but they are very clearly a way for the member state to ensure that the ECB stays on-mission – to be sure that a whistle gets blown if something starts to go terribly wrong. To illustrate this point, suppose that the ECB made a huge, but honest policy mistake (as happens to all decision-makers at one point or the other). Think about which of the following would be more reassuring to, say, German citizens: (1) The Bundesbank President states that he was there when the decision was made and he can testify that 'due diligence' was done; or (2) A highly competent and experienced technocrat from a Latin nation assured the Germans that he was there when the decision was made and he could testify that the decision-makers had 'done their best'. Plainly, Germans would find the first more reassuring and this suggests that the presence of the central bank governors is a form of accountability.

Football match headlines

To put it differently, a central bank governor on the ECB is both a monetary policy expert *and* a national 'listening post,' ensuring that the ECB is ultimately accountable to someone with credibility in the eyes of the various national electorates.

Taking this as given, any rotation or representation scheme may undermine the credibility/accountability of the ECB in the eyes of Europe's citizens. The ECB has been amazingly effective at avoiding what might be called football-match-headlines. When the ECB failed to cut interest rates in March 2001, we did not see the various national presses crying out that this meant that their central bank governor had won or lost. It need not have been like this, however. If, for example, the governors had GDP weighted votes and the whole vote and pre-vote debate were made public, the national presses of various euro members

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8   Note that these changes are likely to be implemented after most of the current governors have left office, so personal concern for their place on the ECB is unlikely to be an important factor in the governors' objections. The exception is the anomalous appointment for life of Italy's governor, an anomaly that should probably be removed.

would have surely reported interest rate decision in 'us versus them' terms. For example, suppose there were an explicit rotation scheme that this year meant there was no Spaniard in the voting loop and that the decision was to 'tighten' when Spain's economy would have been best served by a loosening. The Spanish press might well have a field day at the expense of the ECB's good name.

6.2.4 A recommendation

It is obvious to any outsider that the only solution is delegation to a committee.

   This could coincide with six Executive Board members, or could also include, a few non-executive members as is the case in some other central banks (see Box 6.6). The main trade-off here is effectiveness versus political acceptability. In the political-acceptability extreme, the Committee could consist of 30 members thus allowing, on average, each likely EMU member to have a committee member; this, however, would fail on effectiveness grounds. In the effectiveness extreme, it would consist of the six members as in the current Executive Board. It is hard to know where the line should be drawn, but when faced with a similar problem, the Bundesbank decided on 15 members, with 6 in the Executive Board, but as Table 6.4 showed many nations have opted for a number between 6 and 9, and 9 strikes us as appropriate. Needless to say, there is little science behind this number. For example, the current number of ECB decision-makers is 18 and according to the latest research – Favero et al. (2000), for example – this seems to function well enough.

   Such a set-up has obvious merits.

- It limits the number of individuals responsible for taking monetary policy decisions.
- It de-nationalizes monetary policy, by removing interest rate decisions from a group controlled by national central bank governors and assigning it to individuals clearly identified with the Euro area.
- It enhances the individual accountability of the Executive Board or committee members.

What about the politics of it? If the central bank governors sit on the Governing Council in a personal capacity, and if they do not represent their countries and if they are forbidden to seek or accept instructions from any private or public body, then they are completely independent. In short, if this view is true in its entirety, the Governing Council already is a committee of independent monetary experts. In this case, no one should object to nominating the finest experts in the world, even if he or she does not come from a Euro area member.

   This misses the point made above about the governors' role in terms of accountability. Central bank governors do have some credibility in the eyes of their fellow citizens. If nothing else, they are typically viewed as eminent citizens in touch with national sensitivities. What all this goes to say is that cutting the governors out of ECB process entirely might seriously weaken the ECB's account-ability and political acceptability.

To redress this, and ensure that the full range of monetary conditions have a voice, we suggest that the views of central bank governors could still enter the process but only as information that Board or Committee members use to reach their decision. The central bank governors would continue to be part of the Governing Council, but this would become, as far as monetary policy decisions are concerned, a consultative body, one that ensures that the governors can continue to function in the role as national 'listening posts'.

Selection of the committee members would be another important component of the ECB's accountability. The current process used to select Executive Board members seems to be appropriate to the task.[9]

Analogy with competition policy

The EU has clear supranational executive power in both competition policy and monetary policy. In the case of competition policy, the power is delegated to a committee – the Commission. Decisions are made without formal consultation with either the Council of Ministers or EU members in general. Thus the idea of delegating monetary authority to a committee does have precedence in EU practice.

6.2.5   Modalities: ECB deadlock and the Commission's opportunity

The likely deadlock in the ECB Council

The Treaty of Nice asked for a reform recommendation 'as soon as possible'.[10] The ECB Governing Council has a clear incentive to move fast in proposing a change in the Statutes. If it waits, it may be put in the uncomfortable position of having to respond to a proposal tabled by the Commission. Remember that article 5 of the Nice Treaty specifies that the Council can modify the voting rules of the Governing Council acting on a proposal of the ECB or the Commission; presumably it would act on whoever moves first. Although the Council will certainly consult with the ECB on whatever proposal is put forward by the Commission, and *vice versa*, there will be a clear first-mover advantage. As we have described at length in earlier chapters, the role of agenda-setter can be powerful indeed. For example, if the Commission proposes a workable solution, opposing it would be an uphill battle for the ECB.

Could the ECB move first? The Nice Treaty requires the ECB to act unanimously in making its recommendation for such a proposal, so the incentive to move fast is unlikely to be enough to produce a decision. None of the solutions outlined above (rotation, representation or executive decisions) is likely to gather unanimity among national central bank governors. As in the case of the composition of the Commission, many governors will balk at giving up their vote in the Council, even temporarily, as would be necessary in a rotation system. Wim

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9 'The President, the Vice-President and the other members of the Executive Board shall be appointed from among the persons of recognized standing and professional experience in monetary or banking matters by common accord of the Governments of the Member States at the level of Heads of State or of Government, on a recommendation from the Council, after it has consulted the European Parliament and the Governing Council of the ECB.' Source: ECB Statutes.

10 Declaration 19: 'The Conference expects that a recommendation within the meaning of Article 10.6 of the Statute of The European System of Central Banks and of The European Central Bank will be presented as soon as possible'.

Duisenberg's view (expressed in a March 2000 testimony to the European Parliament) that 'rotation in a relatively small Governing Council is the most likely outcome' is wishful thinking. The big EMU members may want a rotation system in which they get a permanent seat (as in the Fed, see Box 6.4), but smaller members will veto this. Delegating monetary policy to a committee would, in essence take the vote away from all governors. In one way this would cause even bigger problems, but at least all the governors would be in the same boat.

IMF-style representation is also likely to run into political problems. There might be agreement among the current members on a proposal to group together the new entrants, though none of the current members, in a couple of constituencies, carrying one vote each, but it is impossible to design a fair rule that gives a permanent vote to Ireland but not to Hungary. In any case this would not avoid swelling the composition of the Governing Council; at the same time it would break the rule whereby governors vote as individuals, not as representatives of a member central bank.

Postponing, as was done for the Commission, is also not an option. The ECB is a young institution in the process of building a reputation. The current members of the Governing Council should not risk taking a decision that would introduce a lot of uncertainty in the process that drives monetary policy decisions.

This likely deadlock offers a unique opportunity to the Commission.

The chance for the Commission … and the solution it might put on the table
The Commission has the incentive to table the only rational proposal, but has few of the constraints that stop the Council from doing the same. However, the issue is politically very sensitive. The Commission might not dare to put forward a proposal without prior ECB approval, especially given the current controversies on monetary policy and on the succession of President Duisenberg. After all, such a proposal might trigger a public debate on whether the Commission was trying to weaken the ECB. Such politics should not be allowed to lead to a reform stalemate, however. It is plain that the ECB's number problem must be solved. Article 5 of the Treaty, and the surprising agenda-setting power it gives to the Commission, is unlikely to have been drawn up by chance. It was very clear to the European Council that the ECB might not be able to produce a consensus plan; hence the possibility for the Commission to step in and table a proposal.

A more extensive Treaty change
The major drawback of the independent committee solution is that it would probably require a somewhat larger Treaty change than the one enabled by the Treaty of Nice. A change in Article 10.2 of the ECB statutes may not be enough to strip voting rights from the Council, assigning them to the Executive Board, to say nothing of creating a new body 'the monetary committee' made up of the Executive Board and several other independent experts. (A new drafting of Article 10.2 to this effect is likely to clash with Article 12.) As we have argued above, however, there is really nothing that stops a single-issue IGC from extending the changes to the ECB statutes beyond Article 10.2.

<u>6.3</u> **Reform before enlargement**

The above reasoning indicates that enlarging an unreformed monetary union would have grave consequences for EMU monetary policy-making and this establishes the urgency of reforming the monetary union before it is expanded. It should also be clear that this reform should take place before the next EU enlargement.

   The reasons are simple. New entrants will almost surely view the necessary reforms as a retraction of newly granted powers. Since they will have a veto of such reforms (Treaty changes are subject to national vetos in the Council), it will be much harder to get any reform passed after EU enlargement. Moreover, as mentioned above, a very natural price that the newcomers might ask for would be a lenient judgement on the Maastricht criteria ('you can reform it, if we can join it'). The idea that EMU membership was being traded for agreement on reform would do little to bolster the euro's status. Moreover, discussing reform in such a situation could raise doubts about the final outcome – and doubt is all that is needed to trigger negative reactions in financial markets.

   Finally, one sort of reform in particular would need to be made before enlargement. If a view were to emerge that new, tighter criteria should be adopted (for example, one might think of raising the standards of compliance with the Maastricht convergence beyond a single year, requiring, for instance a demonstrated ability to keep within all the Maastricht limits for a period of, say, two years) then this should be decided now, and the Treaty modified accordingly. After all, the candidate countries are assuming, based on the current Treaties, that participation in the euro will happen very soon after accession, and this is indeed one of the main reasons why they press for accession. They will not easily accept reforms that delay their entry.

7 'Entrance Exam' Dates

In its 'declaration on the future of the Union' the Treaty of Nice states that it 'opens the way for enlargement of the European Union and underlines that, with ratification of the Treaty of Nice, the European Union will have completed the institutional changes necessary for the accession of new member states'. EU leaders also made statements that are tantamount to a political commitment to admit at least some newcomers by 2004.

This is not enough.

Enlargement is likely to happen in waves, and there is an important danger that the first wave may delay the subsequent waves. To avoid this, and to provide the proper reform incentives – both to negotiating nations and to the EU itself – the commitment to enlargement should be reinforced by a firm commitment to dates – not accession dates, but Maastricht-style dates. These dates should lock in:

- the first exam date for evaluating which nations are ready to join;
- the date on which accession Treaties would be signed for those who passed the evaluation; and
- the dates of subsequent evaluations and signatures.

Setting such dates is critical. Whatever 'system' of dates is adopted – including the hazy, ever-changing system that is now in operation – the *nature* of the dates has an important impact on the reform process in the CEECs, especially those who are not now among the frontrunners.

This chapter first addresses a much under-appreciated issue – the impact of dates on reform in the candidate countries. In the course of this, we make the simple but important point that the *nature* of the dates matters enormously. Finally, we point out that the ECAs, which pose entry criteria above and beyond accession criteria, would also foster continued transition efforts.

7.1 The dating game: nature and sequencing of dates

The date issue is complex, so a framework for organizing our thoughts is useful.[1] To this end, let us describe the enlargement process in slightly abstract terms, using an analogy. The medical profession has high standards for its doctors and it enforces these with a series of difficult entry tests. While these tests impose

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1   The reasoning in this section is based on Berglöf and Roland (2000).

much sweat and tears on aspiring doctors, they are in the interest of both the medical profession and the would-be doctors. The reason is simply that medical students, like all humans, face a tangle of internal conflicts that typically result in less studying than the students themselves would feel optimal. Examinations that are given on fixed dates are a time-honoured means of helping aspiring doctors to break through their internal conflicts.

The key points here are: (1) the date is an examination date – not a date for becoming a doctor; (2) the examination dates are fixed well in advance; (3) the examination criteria are clear and the evaluation procedure is perceived by all as fair and thorough. Finally, despair and abandonment are avoided since a sequence of exam dates is announced in advance. This means that work will not be entirely wasted if the student fails or, for some unforeseen reason, is unable to fully prepare in time for the first date.

Perhaps a closer analogy comes from the Maastricht Treaty's dates. The first date, 1 January 1997, provided weak reform incentives because of its nature; it was what could be called the only-if-enough-are-ready date. This would be like saying that the MD exam will only be held if enough students have sufficiently prepared themselves. The second Maastricht date, 1 January 1999, provided strong incentives due to its nature. It was what we might call the train-is-leaving-with-or-without-you type. Finally, the Maastricht Treaty locked in a series of exams, not just the first one. Specifically, every two years all non-EMUers are evaluated and those who are sufficiently prepared can join. This meant that although Greece failed the first exam, not all of its pre-1998 reform-related political strife was wasted. Since a new exam was scheduled for 2000, the Greek government had the right incentives to work hard to pass the exam in 1998 even though it knew its chances were slim.

Now, with this analogy in mind, the deleterious impact of adding to the reform-before-enlargement list should be clear. An aspiring doctor would be distraught at the possibility that his exam could be arbitrarily postponed. The best students might react by studying even harder, but many students would be discouraged. Maybe they would even suspend their efforts until the Medical Board made up its mind.

More specifically, to strengthen reform leverage, the criteria for membership should be clear and the evaluation procedure transparent. The criteria used by the EU have been clarified over time, starting from the rudimentary and vague conditions agreed upon at the Copenhagen summit. The *acquis communautaire* is extremely precise, and the question is rather how many of the tens of thousands of detailed requirements will eventually be imposed. The political criterion is obviously open to interpretation, but currently most candidates are viewed as satisfying it. The two economic criteria – the market criterion and the competitiveness criterion – are difficult to make very precise, and the logic for some of the conditions imposed under these broad criteria has yet to be made more explicit and convincing. Recent attempts to involve the European Commission's Directorate General for Economic and Financial Affairs more deeply in the evaluation process may signal that new conditions may be added, possibly related to EMU membership, or at least that the analysis will be deepened in certain areas. Any additional uncertainty about the criteria for entry weakens the leverage of the EU over the reform process in the candidate countries.

Not only entry criteria, but also the meaning of membership in the club, should be clear. The increasing talk of extensive derogation periods in important areas for new entrants dilutes the value of membership and weakens incentives to reform prior to entry. The ongoing differentiation of membership, under the notion of 'flexible integration', i.e. enhanced cooperation, also creates uncertainty about the size of the prize. The applicant countries have legitimate concerns that they will join the EU as second-class citizens deprived of many of the membership benefits.

A Europe with clubs within the club – a sort of 'onion model' EU – may also serve to strengthen the enforcement powers of the EU once countries are inside, however. The EU's enforcement powers are weak, and they may be further weakened by decision-making paralysis after enlargement. The existence of inner circles, such as the EMU area, sustains reform incentives after membership. Once a country has met the Copenhagen criteria, it must try to meet the conditions imposed by the Maastricht Treaty. There is, unfortunately, one catch. Enhanced enforcement inside the EU through the creation of inner circles dilutes the value of belonging to the outer circle, and thus decreases the leverage on countries outside the EU aspiring to accession. For the EU to serve as an 'outside anchor' to the reform process in the accession countries it is critical that membership is seen as a valuable prize that is worth the politically painful reform efforts.

7.1.1 Regatta or big bang?

Another aspect of the enlargement strategy with implications for the process of economic and political reform in Central and Eastern Europe is the choice between letting everybody in at once and dividing applicants in several echelons. So far we have argued for a differentiated strategy based on a schedule with multiple decision dates. There are, however, certain costs with having several waves of entry. New entrants may have to erect new barriers with applicants, which did not qualify on a particular date. The Czech Republic and Estonia had to withdraw their demands to maintain customs unions with Slovakia and Latvia, respectively. Allowing most countries in one wave, the 'Big Bang' strategy currently à la mode in Brussels, would be administratively simpler, but it would undermine the benefits of a merit-based process. The incentives of the frontrunners will probably be weakened since either the threshold will be lower or the decision date moved into the future. For the second-tier reformers the hopes may be increased, but a 'Big Bang' approach is also likely to be associated with more derogation lowering the value of membership.

7.2 Conclusions

The agenda of the upcoming intergovernmental conference in Nice was motivated by Eastern enlargement since the Amsterdam Treaty made institutional reform a precondition for proceeding with enlargement. A cynical observer might conclude that this link was brought about by an unholy alliance between EU members resisting enlargement in general, and those that cared more about deepening than about widening. If, as our calculations suggest, adding a first

wave of entrants seriously undermines the EU's decision-making capability, the momentum for reform post-enlargement should lead to more comprehensive and deeper measures being undertaken. It might, however, be used as an excuse to delay entry of the candidate countries who do not make the first wave. Consequently, establishing a system of dates is even more important, since the list of candidate nations will only grow. Turkey and Switzerland already have made applications and over the next ten years many other European nations – Serbia, Croatia, Macedonia, Albania, Bosnia, and maybe other former Soviet republics – will apply.

Part 3
Next Steps

Part 1 argues that the Nice Treaty will massively alter the EU's functioning; crippling the Council as a legislating body and thus stripping both the Parliament and Commission of the power they derive from influencing new legislation. Further integration, if it occurs, will rely more on member states' initiatives, perhaps channelled into new ECAs.

Part 2 argues that besides failing to achieve its efficiency/legitimacy goal, the Treaty of Nice is lacking since it neither addressed ECB reform nor instituted a system of dates to manage the successive enlargement of the EU.

This raises the question …

8 Should the Treaty be Ratified?

Yes. Institutional reforms can wait; Eastern enlargement should not.

The European ideal was born in the ashes of devastation caused by intolerance and destructive nationalism. The East-West division of Europe is the last remaining element of this pre-1945 world and only Eastern enlargement can remove it. Enlargement will fulfil the aspirations of a 100 million Europeans who chose freedom, democracy and markets; it will ensure political and economic stability in Europe. Enlargement, quite simply, is a historical imperative. Council voting weights are a historical footnote.

Moreover, killing the Treaty would recreate the situation that led up to Nice. The Amsterdam Treaty made EU reform a precondition for enlargement. This sequencing was at least part of the reason why Nice became the longest IGC in history and still did not manage to achieve its goals. When reform was a precondition for enlargement, interests that were lukewarm to enlargement were granted important leverage. If enlargement had been locked in first instead, such 'hostage taking' would have been less effective. Now here is the point.

If the Nice Treaty is ratified, the sequencing will be reversed. Enlargement will happen, but the EU institutions will still need to be reformed. This would mean that the next round of horse-trading over EU reform cannot threaten to delay enlargement over the issue of a couple of votes. Enlargement will have happened or be imminent. There is even hope that the new members will have some say over the future shape of the institutions and this may make the agreed reforms more sustainable.

This is the way it should be. The reform of EU decision-making should be a priority, not a condition for enlargement, but this is possible only if the Nice Treaty becomes law.

Fortunately, Nice also created a window of opportunity for reform by agreeing the IGC 2004.[1] What reform is needed?

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1 The IGC 2004 agenda agreed at Nice does not include institutional reform, but this could be added by common agreement of EU heads of state and government.

<u>8.1</u> The Nice leftovers

Although we have not addressed them directly, the Structural Funds and Common Agriculture Policy are not sustainable long-term in a union that is as economically as diverse as the EU27 will be. More definitely, the EU should:

- fix the ECB's 'numbers problems' by reforming its decision-making procedure – we recommend that the power to set interest rates be transferred to the Executive Board; and
- set a series of 'exam' dates for subsequent enlargements to ensure that the first enlargement does not greatly delay the subsequent ones.

Also, presuming EU leaders want a Council of Ministers that can act, the EU should:

- re-adjust Council of Ministers' voting procedures.

We turn now to how it could be re-adjusted.

<u>8.2</u> Emergency repairs at IGC 2004?

The early morning bargaining that led to the triple majority system will never be remembered as one of the EU's greatest moments. The damage to decision-making efficiency, however, could be repaired with one or two changes that are simple – at least conceptually simple. Here are our proposals.

8.2.1 Lower the 74% threshold to two-thirds

If the EU lowered the Council-vote threshold to two-thirds (230 out of 345 votes to win) and changed nothing else, the efficiency of the EU27 Council would rise to roughly the level it was in the EU12.[2] Moreover the population and member safety nets would prevent a gaggle of small nations ganging up on the big ones, and prevent a minority coalition of big nations forcing their way using their voting power.

   The downside of such a reform, however, is that it tends to reduce the power of small nations further. The implied changes in power shares for the EU15 are shown in Figure 8.1. The intuition for this is that with the lower threshold, the Council-vote criterion no longer dominates the other criteria so thoroughly. In particular, the 62% population criterion begins to bite often enough to favour populous nations, Germany being the biggest winner. This increased power loss for small nations would further disrupt the balance between the union-of-people and the union-of-states, favouring the former. That is the bad news for the small nations. The good news, however, is that at least their power sacrifice would buy something. Under the current threshold, the small nations lose power and yet despite this, efficiency ends up worse than if they had not given up any power.

   Our second proposal would help redress the additional small-country power loss.

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2   The exact passage figure is 14.1%.

Figure 8.1 Winners and losers from a two-thirds vote threshold
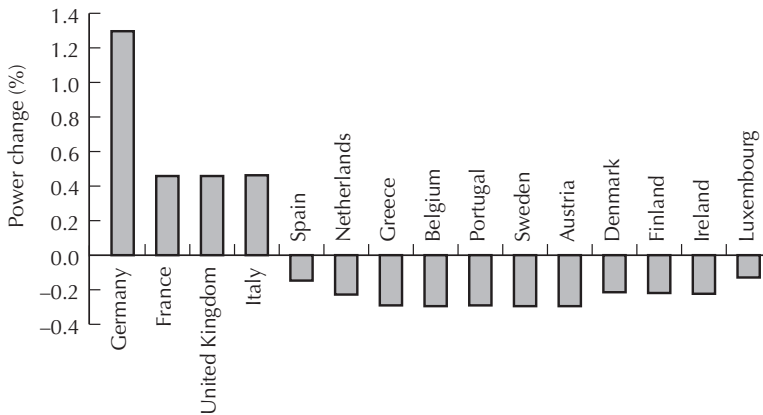
8.2.2 **Lower the population threshold to one-half**

In addition to lowering the threshold to two-thirds of Council votes, the threshold on population should be lowered to 50%. The result of this would be a respectably high passage probability (14.6% specifically, which is about twice that of the EU15 under pre-Nice rules). Moreover, as Figure 8.2 shows, the power shift for this would be much smaller. None of the countries would gain or lose more than a tenth of a percentage point of power. As usual, one should not confuse precision and accuracy; these calculations require us to ignore large swaths of reality, but as a rough guide, we believe they indicate that the 'repaired' system would maintain or even increase the enlarged EU's ability to act without shifting power further away from small nations.

Figure 8.2 Power effects of also lowering the population threshold
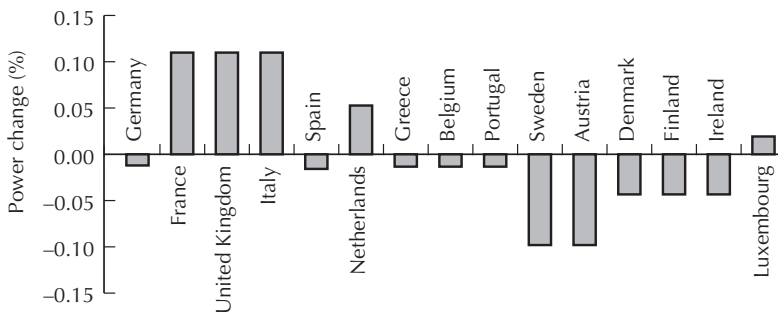
8.2.3　IGC 2004: an opportunity

The reforms we refer to could wait for the 2004 IGC since the Nice reforms on Council voting are not scheduled to take effect until 2005. Leaving these changes till then might be a good idea since by then the first enlargement will be a reality or be near at hand – a fact that should focus minds wonderfully.

All this presumes, however, that EU leaders meant what they said in Cologne, that the goal of the IGC was to 'ensure that the European Union's institutions can continue to work efficiently after enlargement'.

The question still remains …

8.3　Did they mean it?

The sower may mistake and sow his peas crookedly; the peas make no mistake, but come up and show his line.

Ralph Waldo Emerson

Did EU leaders know what they were doing at 4.30 a.m. on Monday 11 December at the end of the longest EU summit in history?

In one view, EU leaders did not realize the strong inefficiency consequences of their actions; the outcome was a collection of unintended consequences stemming from ill-prepared late-night debates. This is not entirely implausible. The Council voting system that was eventually adopted was never discussed during the IGC, so little or no staff-work had been done. Moreover, the Nice reforms do not look so bad from the perspective of the EU15 – the Council that these eminently practical leaders know well. For the EU15, the modest reduction in efficiency stemming from the new 'safety nets' (62% on population and 50% on members) is approximately offset by the modest efficiency gains stemming from the vote reweighting. Yet in the EU27 – a Council that might seem distant and abstract to leaders who are unlikely to hold office for even five more years – the efficiency consequences are dramatic. Efficiency would have been better served by doing nothing. It may also be important that most big members wanted reweighting on the grounds that it would be the simplest solution, and small nations championed the dual majority system to avoid reweighting. It would not be the first time that a committee talked itself into adopting a cocktail of proposals that fails to solve the problems that any individual proposal would have.

In another view, the EU leaders got what they bargained for – a crippled legislative process that strips the Commission and Parliament of their agenda-setting power and the old Community Approach of its viability. In this world-view, future European integration will be guided by intergovernmental initiatives with the large members inevitably playing a role more commensurate with their economic and demographic importance. This view is also not implausible. For some members, integration has reached the upper range of what their votes feel comfortable with. In these countries the leaders may be quite satisfied with an EU where the key institutions are seriously constrained and decisions are mainly taken directly between governments. There may also be those who never accepted the notion that a dozen or more small nations – nations whose populations are smaller than a big city – should have a major say in how to run a

Europe that produces a third of world output and has close to 500 million citizens. Holders of this view may also be satisfied with Nice.

The question of which view is correct matters greatly for what comes next.

- If it was an oversight – at least in the eyes of most members – then there is still time for some emergency repairs and IGC 2004 provides a perfect opportunity.
- If it was wilful, efforts to reform the system will be fruitless; at least not until the enlarged EU experiences a high-profile decision-making crisis or two (e.g. a deadlock in the 2006 negotiations on the next financial perspective that threatens to leave the EU without a budget, or a deadlock over CAP and Structural Funds reform).

In short, the Treaty of Nice was a nice try, good enough for a start. Although it failed to adjust EU decision-making to the realities of an EU with 27+ members, it did open the door to enlargement. It should be ratified and then repaired.

Appendix 1 How Much Efficiency is Enough?

The efficiency of the EU's decision-making has waxed and waned over the decades, but the coming enlargement will provide a shock of an unprecedented size. In just five or ten years, the membership will nearly double. In this section we propose a framework for thinking about how much efficiency is enough.

A1.1 An analytical framework

We start by considering an abstraction.

Think of integration/liberalization being implemented by 'parcels'. Each parcel – as is true of virtually all liberalization – creates political economy winners and losers, so some parcels will be more contentious than others. For the least contentious parcels – call them everyone-a-winner parcels – each member state wins on net. For others, some member states may be net losers even though the net to all member states taken together is positive (i.e. the winners win more than the losers lose). Call these EU-gains-on-the-whole parcels. The third type of parcel is where some member states win but the sum of wins and loses across the EU is negative.

The everyone-a-winner parcels would be easy to get passed, even under unanimity voting. The EU-gains-on-the-whole parcels are a different matter. Taken in isolation, an EU-gains-on-the-whole could not pass under unanimity, yet they can be pass by 'bundling'. That is, the Commission often bundles together several parcels, carefully choosing the combination to guarantee that any loss a member suffers from a particular parcel is offset by gains from other parcels in the bundle. In this way, the Commission can create an everyone-a-winner package.

So far we have referred to unanimous voting. The same points apply, however, to qualified majority voting (QMV). Some uncontentious parcels are easy to pass in isolation; others are passable only when bundled with other parcels. In one sense, qualified majority is just a way of bundling over time. That is, under QMV, members know that they will occasionally lose and occasionally win, but given that the Commission is fair, the gains from the wins will outweigh the losses. This may be attractive since the alternative would be to wait a very long time to be able to gather together a something-for-everyone package.[1]

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1 In essence, this was the motive for switching to QMV on Single Market issues. Members knew that this would lead to instances where they were out-voted but, averaged over several years, each member would come out a net winner from the resulting liberalization. Moreover, the alternative – doing everything by unanimity – proved to be monumentally slow in the 1970s and early 1980s. The key trade-off, therefore, was doing something now that might be viewed as imperfect or even harmful by some members versus waiting decades to put together the perfect package. Indeed, since the economic environment is continuously changing, long delays might be sufficient to prevent any effective liberalization. As Michael Emerson said of the 'old approach' to approximation of laws, exhaustively detailed directives were 'difficult to agree and quick to become obsolete' (Emerson et al., 1989).

A1.1.2   **The optimal efficiency diagram**

With these preliminaries out of the way, we turn to a diagram to help organize our thinking about the optimal level of efficiency. Figure A1.1 plots the quantity of integration/liberalization (on the horizontal axis) against the cost and benefit of parcels measured in euros (vertical axis). These integration/liberalization parcels are arranged on the horizontal axis in order from the highest net gain parcels to the lowest net gain, and we allow for the possibility that some parcels would yield a net loss (i.e. negative net gain). Furthermore, we presume that this ranking is also correlated with the contentiousness of the parcels, so that parcels listed far out on the integration/liberalization axis are more contentious.

Members and Commission demand for integration
The D^{ms} curve in Figure A1.1 shows a typical member state's perception of the marginal gain of the various parcels (this can be thought of as a members' demand curve for integration/liberalization). Our ordering of parcels ensures that members expect a lower net gain as more parcels are adopted. For simplicity we ignore differences among member nations.

In this stylized world, the total benefit from integration rises for every integration parcel that has a positive net value in the eyes of the members. So, all integration parcels up to Q^* should be adopted. In the jargon, Q^* is the optimal degree of integration from the members point of view.

In a very perfect world – where EU members could coordinate among themselves perfectly – this Q^* could be achieved by pure intergovernmentalism; there would be no need for the Commission. In reality, however, it is quite impossible for members to exactly agree upon the D^{ms} curve. Given the 'fog of policy-making', members would disagree over the exact net gain and the exact

Figure A1.1 Optimal efficiency in EU decision-making
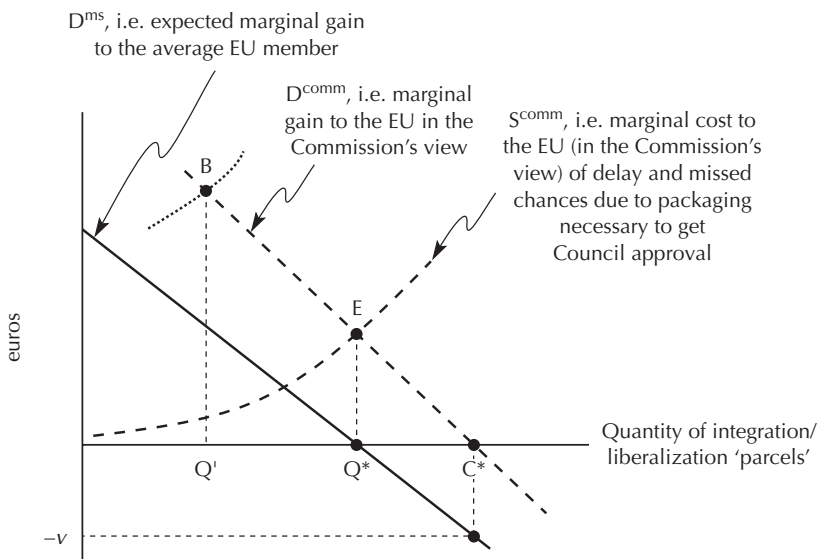
distribution of gains for almost every parcel. Moreover, someone would have to define the parcels precisely, i.e. to formulate the policy options. Because each member has an incentive to divide up integration into packets that favour their own nation, the members would have a very hard time simply agreeing on the exact shape of the parcels to consider.

These two decision-making problems, information and policy specification, are widely recognized in all democratic bodies and the common solution is to appoint an agenda-setter or executive body that has the obligation to gather information and to set the agenda. In most Parliaments, Committees and/or Ministers play this role. In the EU, the Commission does it.

The problem with such Executives is that they often have a different perception of the net gains from legislation. In the EU's case, the Commission is typical more pro-integration than the average member state. What this means in the diagram is that the Commission's demand curve for integration, shown with the dashed line, D^{comm} curve, is above the members' demand curve D^{ms}. The reason is that – in our framework – the Commission has a higher evaluation of the net benefit of each and every integration parcel.

Checks and balances

Given that EU members know that the Commission is more forward leaning on integration than the average member state, the founding members set-up a system of checks and balances. To see why, consider how the Commission would act without the checks and balances imposed by the Council, i.e. if the Commission was a philosopher-king that could unilaterally impose any level of integration it wished. In the Commission's view, all parcels up to C^* should be adopted in order to maximize its perception of EU well being. Yet since the Commission is more pro-integration than the members, adopting the proposal in the range Q^* to C^* would, in the members perception, lower the EU's well-being; the point is that members view the Q^* to C^* parcels as having a net negative impact on the average EU member. For example, the members' perception of the net gain from the last parcel adopted is $-v$. Given this, adding the Q^* to C^* parcels to Q^* would – in the members' point of view – worsen the situation.

In 1887, Lord Acton wrote 'absolute power corrupts absolutely'; this is no less true today, so the founding EU members never seriously contemplated a system that allowed the Commission a free hand in imposing integration/liberalization. Even putting ill-intentions to the side, however, member states would want to constrain the Commission in some way to avoid over zealous integration efforts. In terms of economic jargon, this is a variant of the principle-agent problem.

The system actually adopted is one that requires the Commission to convince a sufficient number of member governments that their proposal will actually improve EU welfare, *from the perspective of the members themselves*. This system, however, imposes new costs, to which we turn next.

Delay/missed opportunity costs facing the Commission

First, consider issues that require unanimous approval in the Council. As discussed above, some parcels could pass the unanimous test all alone. Other proposals, however, must be combined to present a package that has 'something for everyone'. Forming these sorts of packages is a time-consuming activity. The Commission must ascertain the strength of each member state's opposition or

support for each parcel. It takes time for members to evaluate the parcels and in the end, given the intrinsic uncertainty involved in policy-making, the member state themselves may be very uncertain about the strength of their own feelings. Moreover, they may wish to 'hold their cards close' to gain a tactical advantage. As discussed in Chapter 5, such delays were real and really long in the 1970s; many proposals to advanced the completion of the internal market took ten years or more to pass.

This delay is costly in the eyes of the Commission. It delays integration/liberalization and it may mean missing opportunities. Importantly, we assume that the deeper is the integration the Commission wishes to pass, the longer and therefore the more costly is the delay – again in the eyes of the Commission. That is, if the Commission wanted to pass only the uncontentious parcels, the delay cost would be very low, maybe even zero. To get a more ambitious package of integration passed requires more time, however, and since the deeper is the integration, the more controversial are the parcels, the marginal cost of adding parcels rises with the number of parcels. In the optimal efficiency diagram (Figure A1.1) this is shown as a rising S^{comm} curve. This can be thought of as a supply curve since it tells us how much integration the Commission would find optimal at a given 'price', i.e. marginal gain from integration.

Given this Council-imposed rising delay-cost of integration, the Commission will find the optimal level of integration to be at E, rather than C^*. Why? At this point, the marginal benefit to the EU – as viewed by the Commission – of passing one more parcel just offsets the marginal cost of the extra delay that this would entail.

Implications for optimal efficiency

The set-up we have described shows that the Council has an incentive to make decision-making somewhat costly to the Commission. It does this to prevent the Commission from going all the way to C^*. The optimal marginal cost curve – from the perspective of the member states – is to arrange things such that the marginal delay cost curve, namely S^{comm}, crosses the D^{comm} curve just above Q^*.

What does this mean for the optimal level of decision-making efficiency measured by, say, the passage probability? Answering this requires us to establish a link between the passage probability and the position of the marginal delay cost curve S^{comm}. If the passage probability were 1, then the delay costs is zero for any level of integration since the Commission could pass whatever it proposed. In this extreme case, the Commission would choose to pass parcels up to its preferred outcome C^*. At the other extreme, if the passage probability were close to zero, the marginal delay costs would be very high since it would be extremely difficult to formulate a package of parcels that would meet the approval of the Council. For example, a very low passage probability would correspond to a S^{comm} that intersects the D^{comm} at point B, resulting in a level of integration shown as Q'. Both of these extremes would be disadvantageous for the member states; C^* is too much efficiency and Q' is too little. Plainly, the optimal level of efficiency would slow down the process just enough to ensure that the Commission found it optimal to propose Q^*.

It is not possible to read off the optimal level of efficiency from the diagram, but this is no great loss since the exact number is virtually meaningless; the Commission does not put forward random proposals. What the diagram helps explain is why the system is designed to have an intermediate level of efficiency.

A 1.2 QMV vs. unanimous voting

EU members have arranged decision-making in a way that makes it much harder for the Commission to put together a winning proposal on certain types of decision. Our diagram helps us organize our thinking about this.

On certain issues, member states have views on further integration/liberalization that diverge sharply from the views of the Commission – tax harmonization, social legislation, and free trade in cinema films are just three examples. There may be several reasons for the divergence. The average Commissioner may underestimate the value of sovereignty to some member states. Commissioners may also take a longer view than elected leaders of member states, and finally the Commission is charged with the task of deepening European integration, so that it is a Commissioner's duty to be more forward leaning than the most reluctant members. Importantly, the distance between the Commission's and the member states' evaluation of the marginal benefits of further integration varies across issues.

When the Commission is far ahead of the members states, or member states are worried that it might be, the member states have insisted on unanimity in the Council to pass a Commission proposal. The point is that unanimity raises the marginal cost of delay, the result is that the resulting level of integration is closer to the preferences of member states. In Figure A1.2, we have illustrated this situation with dashed D^{ms}, D^{comm} and S^{comm} lines. As drawn, the equilibrium outcome, $Q^{*'}$ is exactly equal to the preferred point of the member states, but of course in reality we would expect only that the outcome would be near $Q^{*'}$.[2]

Figure A1.2 QMV vs. unanimous voting

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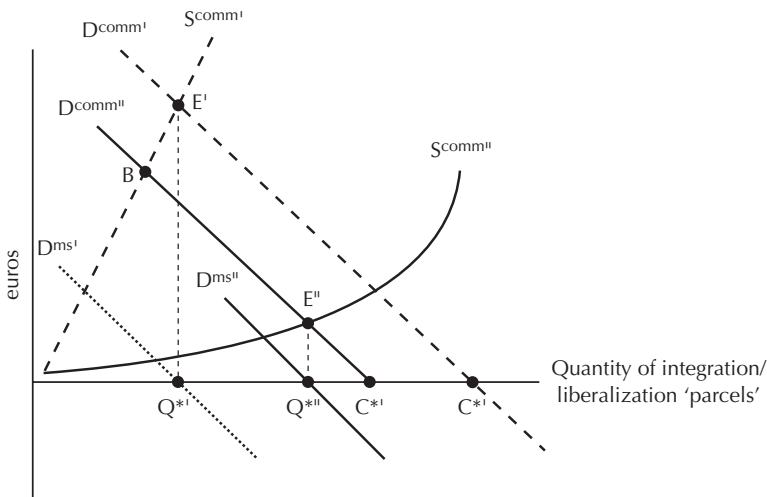
2 There is another reason for unanimity. For simplicity, we have assumed that all members are symmetric. On certain issues, however, members may have very divergent views with some members having extremely strong preferences on particular items. Unanimity ensures that no bundle of integration packets can pass unless they are fully compensated on the areas of greater concern.

On other issues, like Single Market issues, the Council and the Commission are likely to be much closer. For such issues the Council does not need to constrain the Commission too much, so qualified majority voting (QMV) will do. Since it is easier to get any proposal accepted by QMV, the marginal delay costs facing the Commission are lower so they choose a higher level of integration, point E" in the diagram. If the Council imposed unanimity on such issues, the Commission would only propose up to point B and this would result in less integration/liberalization than the members would like.

In a sense QMV is a way of bundling integration parcels over time. Each member knows that he may occasionally be out-voted on a particular issue, but this is balanced by wins on other issues in future Council sessions. One can thus think of QMV as a sort of intertemporal bundling. Of course, all this assumes that the Commission is a fair broker and does not continuously ignore the interest of any member. This latter point may help explain why members are so keen on having at least one Commissioner.

A1.3 Impact of enlargement

We can also use this framework to consider the impact of enlargement. The key is enlargement's impact on the Commission's marginal cost of proposing deeper integration/liberalization, i.e. on S^{comm}. Without a doubt, it is harder to arrange a bundle that will win with 27 members than it is with 15. Thus this enlargement will clearly shift up the S^{comm} curve as shown in the Figure A1.3, if there were no change in the QMV procedure. The result would be a clear reduction in the flow of integration/liberalization parcels being adopted.

In Figure A1.3, the post-enlargement without reform outcome would be at point A. The important point to note is that the resulting flow of liberalization,

Figure A1.3 Enlargement and efficiency
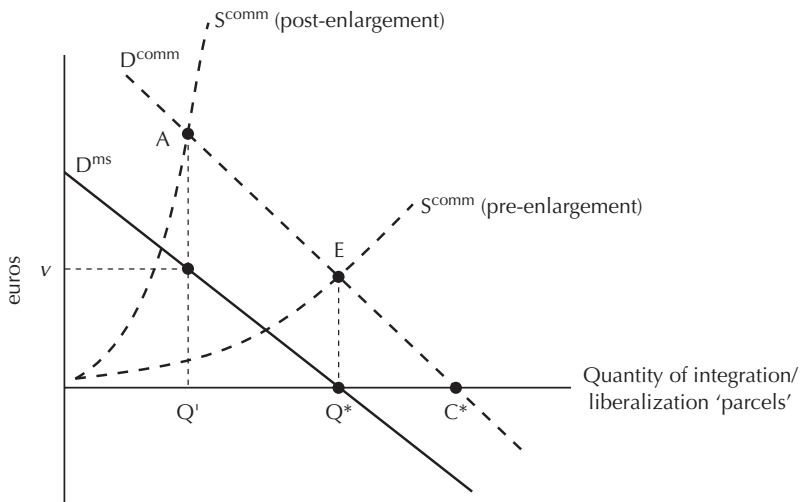
namely Q', is lower than member states would find optimal (this presumes that the newcomers have approximately the same evaluations of integration as the incumbents). One way to see this is to note that at the new equilibrium outcome, the marginal liberalization parcel provides a positive value (namely '*v*' in the diagram) to members. The solution to this quandary – as EU leaders recognized in the Amsterdam Treaty – is to make QMV decision-making easier, by, for instance reweighting votes or switching to a double simple majority system.

The framework presented here is extremely simple but it helps us think about why the Council wants to make it hard for themselves to pass legislation proposed by the Commission and why they set-up the Commission in the first place rather than forming their own committee system to develop proposals (as most Parliaments do).

<u>A1.4</u> Efficiency and the outside options

When it is relatively easy to pass legislation, the Commission tends to pursue its integration initiatives via the legislative route. When the legislative route is very difficult, however, the Commission may turn to its outside options of appealing to the Court (as it did in the 1970s over the issue of national product standards that acted as trade barriers), or directing its power to implement existing legislation (as it has done recently with its aggressive enforcement of competition policy).

To explain this we return to Figure A1.3. If you recall, the flow of integration/liberalization proposals that the Commission finds optimal to put forward is determined by the intersection of the supply and demand curves, S^{comm} and D^{comm}. The former shows the increasing marginal cost of the delays entailed in trying to get more integration passed by sewing together complex packages of deals. The latter shows the Commission's valuation of the marginal gain to the EU of more integration.

When the marginal cost of passing legislation is low enough, for example, $S^{comm'}$, the Commission pursues most or all of its integration initiatives via the legislative route. When the legislative route is very difficult, however – as it was in the 1970s for instance – the Commission turns to its outside options. To understand why the ECJ can be powerful, one only needs to recall that the Treaties have the force of law in all member nations, and the Court is the ultimate interpreter of the Treaties. This would matter little except for the fact that the EU's founders put some quite radical notions of integration into the Treaty of Rome, and although subsequent EU governments have tried to ignore these, the ECJ may and indeed has enforced the original ambitions. An example of this in the Single Market field is provided below.

To see this in the optimal efficiency diagram (see Figure A1.4), we have drawn in the marginal cost of using the outside option with the line marked S^{ECJ}. The placement of the curve indicates that it is quite expensive, in the eyes of the Commission, to use appeal to the ECJ as a means of advancing integration. The costs are, however, largely immaterial, i.e. the possibility of alienating member states, so they do not necessarily increase with the degree integration. Given this new curve, we find that the Commission will pursue a level of integration corresponding to Q, with part of this, up to Q" undertaken via the Council and part Q" to Q undertaken via the administrative or judicial route.

Figure A1.4 Enlargement, decision-making efficiency and the flow of integration/liberalization
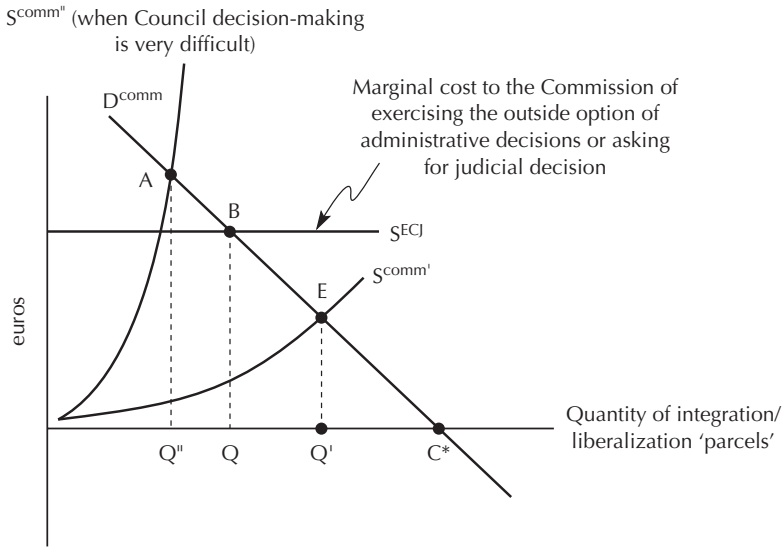
Appendix 2 Calculating the NBI

A2.1 Calculating the NBI for a simple example

To make the Banzhaf index a little more transparent, consider a toy model of the Council of Ministers. This Council comprises three countries, A, B and C, with votes equal to 50, 25 and 25 respectively; the majority threshold is 71% to pass any particular proposal.

To calculate this power measure, one writes down all the winning coalitions. This is done in the left-most column of Table A2.1. One then lists, for each coalition, the nations that can 'break' the coalition in the sense that their defection would make the coalition lose. This is done in the second column. Finally, one determines the proportion of total swings that are attributed to each nation. The results, the so-called Normalized Banzhaf Index (NBI) numbers, are listed in the right-most column.

Table A2.1 Numerical examples of the Banzhaf power index calculation

List of all winning coalitions	Who can 'break' the coalition?	Number of 'breaks' per nation	Normalized Banzhaf Power Index
A, B	A, B	A = 3	A = 3/5
A, C	A, C	B = 1	B = 1/5
A, B, C	A	C = 1	C = 1/5
		Total breaks = 5	

Notes
Votes per nation: A = 50, B = 25, C = 25.
Total votes = 100.
Majority threshold = 71 votes.

Clearly, this measure of power provides a very shallow depiction of a real-world voting processes. For instance, the questions of who sets the voting agenda, how coalitions are formed and how intensively each country holds its various positions are not considered. In a sense, the equal probability of each coalition occurring and each country switching its vote is meant to deal with this shallowness. The idea is that all of these things would average out over a large number of votes on a broad range of issues. Thus, this measure of power is really a very long-term concept.

Another way of looking at it is as a measure of power in the abstract. It tells us how powerful a country is likely to be on a *randomly chosen issue*.

A2.2 Historical power measures for the EU

The actual vote shares and the NBI numbers for the historical EU are shown in Tables A2.2 and A2.3. The salient feature of these tables is the remarkable similarity between the measures. Despite the overall similarity, there are some systematic differences. The NBI is systematically lower than voting weights for the big nations and systematically higher for the small nations.

Table A2.2 Normalized Banzhaf Index for EU6–EU15

	NBI (%)				
	EU6	*EU9*	*EU10*	*EU12*	*EU15*
Austria					4.8
Belgium	14.3	9.1	8.2	6.7	5.9
Denmark		6.6	4.1	4.5	3.6
Finland					3.6
France	23.8	16.7	15.7	12.8	11.2
Germany	23.8	16.7	15.7	12.8	11.2
Greece			8.2	6.7	5.9
Ireland		6.6	4.1	4.5	3.6
Italy	23.8	16.7	15.7	12.8	11.2
Luxembourg		1.6	4.1	1.8	2.6
Netherlands	14.3	9.1	8.2	6.7	5.9
Portugal				6.7	5.9
Spain				10.9	9.2
Sweden					4.8
United Kingdom		16.7	15.7	12.8	11.2
Total	**100**	**100**	**100**	**100**	**100**

Source: Authors' calculations.

Table A2.3 Council of Minister vote shares, EU6–EU15

	Vote shares (%)				
	EU6	*EU9*	*EU10*	*EU12*	*EU15*
Austria					4.6
Belgium	11.8	8.6	7.9	6.6	5.7
Denmark		5.2	4.8	3.9	3.4
Finland					3.4
France	23.5	17.2	15.9	13.2	11.5
Germany	23.5	17.2	15.9	13.2	11.5
Greece			7.9	6.6	5.7
Ireland		5.2	4.8	3.9	3.4
Italy	23.5	17.2	15.9	13.2	11.5
Luxembourg	5.9	3.4	3.2	2.6	2.3
Netherlands	11.8	8.6	7.9	6.6	5.7
Portugal				6.6	5.7
Spain				10.5	9.2
Sweden					4.6
United Kingdom		17.2	15.9	13.2	11.5

Source: Authors' calculations.

Table A2.4 Power indices pre- and post-Nice, EU27 and EU15

	EU27			EU15			EU36
	NBI with no reform	NBI with Nice reforms	Gain	NBI with no reforms	NBI with Nice reforms	Gain	NBI
Germany	0.0695	0.0778	0.0083	0.1116	0.1210	0.0094	0.061037
United Kingdom	0.0695	0.0778	0.0083	0.1116	0.1197	0.0081	0.0610
France	0.0695	0.0778	0.0083	0.1116	0.1197	0.0081	0.0610
Italy	0.0695	0.0778	0.0083	0.1116	0.1197	0.0081	0.0610
Spain	0.0586	0.0742	0.0156	0.0924	0.1109	0.0185	0.0584
Netherlands	0.0384	0.0397	0.0013	0.0587	0.0549	–0.0038	0.0319
Greece	0.0384	0.0368	–0.0016	0.0587	0.0515	–0.0072	0.0296
Belgium	0.0384	0.0368	–0.0016	0.0587	0.0515	–0.0072	0.0296
Portugal	0.0384	0.0368	–0.0016	0.0587	0.0515	–0.0072	0.0296
Sweden	0.0311	0.0309	–0.0002	0.0479	0.0430	–0.0049	0.0249
Austria	0.0311	0.0309	–0.0002	0.0479	0.0430	–0.0049	0.0249
Denmark	0.0235	0.0218	–0.0017	0.0359	0.0313	–0.0046	0.0176
Finland	0.0235	0.0218	–0.0017	0.0359	0.0313	–0.0046	0.0176
Ireland	0.0235	0.0218	–0.0017	0.0359	0.0313	–0.0046	0.0176
Luxembourg	0.0157	0.0125	–0.0032	0.0226	0.0196	–0.0030	0.0101
Poland	0.0586	0.0742	0.0156				0.0584
Romania	0.0456	0.0426	–0.0030				0.0342
Czech Republic	0.0384	0.0368	-0.0016				0.0296
Hungary	0.0384	0.0368	–0.0016				0.0296
Bulgaria	0.0311	0.0309	–0.0002				0.0249
Slovakia	0.0235	0.0218	–0.0017				0.0176
Lithuania	0.0235	0.0218	–0.0017				0.0176
Latvia	0.0235	0.0125	–0.0110				0.0101
Slovenia	0.0235	0.0125	–0.0110				0.0101
Estonia	0.0235	0.0125	–0.0110				0.0101
Cyprus	0.0157	0.0125	–0.0032				0.0101
Malta	0.0157	0.0094	–0.0063				0.0076
Norway							0.0176
Iceland							0.0076
Albania							0.0176
Bosnia-Herzegovina							0.0176
Yugoslavia							0.0296
Croatia							0.0176
Macedonia							0.0101
Switzerland							0.0249
Turkey							0.0610

Source: Authors' calculations.

Appendix 3 Formal Tests of Our Power Measure

Power and love are alike in that both are immeasurable, although their impact is unmistakable. Here we use the impact of power on budget allocations to test econometrically whether our various power indicators capture power in a meaningful way.

A3.1 Estimating equations

Before turning to the evidence, we discuss the two competing budget models, what we call the 'power politics' model and the 'Father Christmas' model.

A3.1.1 The 'power politics' model of the EU budget priorities

In Chapter 3 we argued that a process of 'back scratching' and 'log rolling' would allow nations who were frequently critical in winning coalitions to get more favourable budgetary treatments (see Chapter 3). This established a link between a country's NBI and its budget share and indeed, the implied empirical model, in level and *per capita* terms, is:

(1) *Levels*: (Member budget share) = C + ρ (power measure) + ε

Per Capita: (Member budget share) / population = C + ρ (power measure / population) + ε

where C and ρ are parameters to be estimated and ε is the stochastic error term.

We shall try three different power measures, the SSI, the NBI and the raw number of Council votes. Note that the power indices (accept raw votes) change with the composition of the Council, so we pool data from the EU12 period (1992–4), and from the EU15 period (1995–9).

A3.1.2 The 'Father Christmas' model

A popular, alternative view of the EU budget focuses on the spending principles, mainly poor regions and agriculture. For example, in Baldwin et al. (1992), David Begg estimates a model of the EU budget in which *per capita* receipts from the Common Agricultural Policy depend upon the share of a nation's GDP accounted for by agriculture, and the *per capita* structural funds/cohesion funds receipts depend upon *per capita* GDP. In reduced form, this model of the budget would be:

(2)   (Member budget share)/population = C + α (agriculture GDP share) + β (GDP/population) + ε

A3.2 Econometric results

A3.2.1 The 'pork-barrel' politics model

Table A3.1 shows the detailed Generalized Least Squares (GLS) regression results for equation (1) during 1992–4 for the EU12 data using the SSI/population power measure (PC_SSI and PC_E_SHARE stand for *per capita* SSI and expenditure share, respectively). Note the remarkably high goodness of fit, as evidenced by an R^2 of 0.97. The fact that we are working with cross-section data makes this statistic truly remarkable. It is also noteworthy that the point estimate of ρ has a t-statistic of almost 36. The estimate of ρ, about 1.2, is statistically different from the theoretical value of 1.0, but the constant term does seem to be zero.

Table A3.1 Detailed regression results for a typical regression

Dependent variable: PC_E_SHARE
Method: Pooled least squares
Date: 11 September 00 *Time*: 10:10
Sample: 1992–4
Included observations: 3
Total panel (balanced) observations: 36

Variable	Coefficient	Std. Error	t-statistic	Prob.
C	–9.95E-10	3.45E-10	–2.886785	0.0067
PC_SSI	1.189889	0.033410	35.61448	0.0000
R-squared	0.973894	Mean dependent var.	7.40E-09	
Adjusted R-squared	0.973126	S.D. dependent var.	9.21E-09	
S.E. of regression	1.51E-09	Sum squared resid.	7.75E-17	
F-statistic	1268.391	Durbin-Watson stat.	0.448360	
Prob(F-statistic)	0.000000			

Note: PC_SSI and PC_E_SHARE stand for *per capita* SSI and expenditure share

Source: Authors' calculations.

A summary of such results for the other power measures (NBI/population; votes / population; and for comparison SSI/population) on the 1992–4 data is displayed in Table A3.2. The table also presents the results for the regressions run on levels rather than *per capita* values. To control for inflation, business cycle-related spending changes and budget revisions, we also run the regression with year dummies. These turn out to be insignificant in all cases.

In all cases, the R^2 remains remarkably high for cross-section data. Moreover, all the point estimates are significant at any conceivable level of confidence and the ρ's are close to their theoretically predicted value of unity. Table A3.2 (b) shows the results for the same set of regressions run with the power measures

Table A3.2 1992–4 regression results for power politics model

(a) *Per capita* estimates (dependent variable is *per capita* budget shares)

	ρ	t-statistic	R²	Constant	t-statistic
SSI/pop.	1.2	36	0.97	–9.95E–10	–3
NBI/pop.	0.8	37	0.98	6.69E-10	2
Votes/pop.	0.51681	26	0.95	2.24E-09	6
With year dummies					
SSI/pop.	1.18992	35	0.97	–1.05E-09	–2
NBI/pop.	0.80018	36	0.98	6.08E-10	1
Votes/pop.	0.51682	25	0.95	2.18E-09	3

(b) Level estimates (dependent variable is budget shares)

	ρ	t-statistic	R²	Constant	t-statistic
SSI	1.02823	11	0.77	–0.002	–0.3
NBI	1.14459	11	0.77	–0.012	–1
Votes	1.10091	10	0.76	–0.008	–1
With year dummies					
SSI	1.028230	10	0.77	–0.002	–0.2
NBI	1.144594	10	0.77	–0.012	–1
Votes	1.100907	10	0.76	–0.008	–1

Source: Authors' calculations.

that were calculated for the combined Commission–Council game discussed in the text. Largely, the results are quite similar for the Council only and Commission–Council power measures, with both doing quite well.

Table A3.3 shows the analogous figures for the 1995–9 period. The model fits this period almost as well, and again fixed-year effects do not seem to change anything in a significant way (each of the year dummies are individually insignificant) The point estimates for *per capita* power, however, are all much smaller. A visual inspection of the data suggests that Luxembourg is an outlier in the 1994–9 data since the last enlargement raised its power significantly and this has not been matched by an increase in its already high *per capita* receipts.

To eliminate the possibility that Luxembourg is a source of distortion for all the results, we include a dummy for Luxembourg for the *per capita* specification and the two sub-periods, 1992–4 and 1995–9. Table A3.4 presents the results. In three of the four regressions, the Luxembourg dummy is indeed significant. More importantly, comparing results, we see that inclusion of the dummy makes the estimated coefficient on our variable of interest, namely the power index, more stable across periods.

Table A3.3 1995–9 regression results for power politics model

(a) *Per capita* estimates (dependent variable is *per capita* budget shares)

	ρ	*t-statistic*	R^2	*Constant*	*t-statistic*
SSI / pop.	0.6069	28	0.91	1.23E-09	4
NBI /pop.	0.46104	27	0.91	1.69E-09	6
Votes /pop.	0.52409	27	0.91	1.45E-09	5
With year dummies					
SSI /pop.	0.60678	27	0.91	8.81E-10	2
NBI /pop.	0.46096	26	0.91	1.34E-09	2
Votes /pop.	0.52398	27	0.91	1.10E-09	2

(b) **Level estimates (dependent variable is budget shares)**

	ρ	*t-statistic*	R^2	*Constant*	*t-statistic*
SSI	1.322105	15	0.74	–0.0190	–3
NBI	1.49648	15	0.76	–0.0331	–5
Votes	1.39105	15	0.75	–0.0261	–4
With year dummies					
SSI	1.322105	14	0.74	–0.02	–2
NBI	1.496482	15	0.76	–0.0331	–3
Votes	1.391049	14	0.75	–0.0261	–3

Source: Authors' calculations.

Table A3.4 Power politics results with Luxembourg dummy

(a) **1992–4 regression results with Luxembourg dummy (dependent variable is *per capita* budget shares)**

	ρ	*t-statistic*	*Luxembourg dummy*	*t-statistic*	R^2
SSI / pop.	0.9990	12	5.63E-09	3	.98
NBI / pop.	0.8989	12	–4.18E-09	–1	.98

(b) **1995–9 regression results with Luxembourg dummy**

	ρ	*t-statistic*	*Luxembourg dummy*	*t-statistic*	R^2
SSI / pop.	0.94088	8	–1.50E-08	–3	.92
NBI / pop.	0.79461	8	–1.96E-08	–3	.92

Source: Authors' calculations.

A3.2.2   Father Christmas results

Again, this is estimated on the two sub-periods, namely before and after the most recent enlargement, and with and without a dummy for Luxembourg.

Table A3.5 Estimating the 'Father Christmas' model

(Dependent variable is *per capita* budget shares)

	Agriculture share	t-statistic	GDP /pop.	t-statistic	Luxembourg dummy	t-statistic	R^2
1992–4	1.96E-09	3	1.81E-12	5	–		.45
	8.12E-10	4	–2.47E-14	–0.1	3.33E-08	16	.94
1995–9	1.16E-09	4	1.14E-12	7	–		.39
	6.02E-10	4	–6.72E-14	–0.7	2.80E-08	19	.90

Source: Authors' calculations.

The results, shown in Table A3.5, are not good. When the Luxembourg dummy is excluded, the income-level variable is significant with the 'wrong' sign, in that the point estimate on the GDP *per capita* suggests that rich nations get more per person than poor ones. By contrast, agriculture has the right sign and is significant. The R^2 is 0.45, which is normally considered good for cross-section data. The dominant influence of Luxembourg can be seen in several ways. First, the R^2 statistic more than doubles. Second, including the dummy switches the sign of the estimated GDP/population coefficient and turns it from highly significant to insignificant at the normal level of statistical confidence.

A3.2.3   A statistical horse race: testing the nested model

The final task in this statistical section is to test which model performs better, or, more precisely, whether there is anything left to explain after accounting for the impact of power on the budget priorities. To this end, we estimate the combination of the two models on the two periods, again with and without the Luxembourg dummy.

The results are in Table A3.6. Consider first the findings for the 1992–4 period, which are listed in part (a). These show that both power indices continue to have a statistically significant influence on the spending pattern in all combinations. The agriculture share and income-level variables, however, are not consistently significant. In the 1992–4 period, the income variable is never significant and the agriculture variable is only significant if the Luxembourg dummy is included.

Part (b) of the table gives the corresponding results for the second period. Here we find again that the power measures are highly significant and have the right sign. What is different is that the *per capita* GDP variable becomes significant and has the expected sign in all cases.

In summary, the horse race is clearly won by the power-based view of the EU budget, although there is some evidence that redistributive motives play some role.

Table A3.6 Nested testing of the two models

(a) 1992–4 regression results (dependent variable is *per capita* budget shares)

	ρ	t-statistic	Agriculture share	t-statistic	GDP/ population	t-statistic	Luxembourg dummy	t-statistic	R²
SSI / pop.	0.83924	10	2.52E-10	2.2	-9.57E-14	-1.2	1.14E-08	4.9	.99
	1.19353	26	9.00E-11	0.6	-5.77E-15	-0.06	–		.97
NBI / pop.	0.75373	10	2.52E-10	2.1	-1.02E-13	-1.2	3.29E-09	1.1	.99
	0.82736	34	2.10E-10	1.9	-8.98E-14	-1.1	–		.98

(b) 1995–9 regression Results (dependent variable is *per capita* budget shares)

	ρ	t-statistic	Agriculture share	t-statiistic	GDP/ population	t-statistic	Luxembourg dummy	t-statistic	R²
SSI / pop.	0.81538	7	2.23E-10	1.9	-1.80E-13	-2.4	-6.74E-09	-1.4	.94
	0.66574	25	2.85E-10	2.7	-1.75E-13	-2.4	–		.94
NBI / pop.	0.6892	7	2.29E-10	2.0	-1.84E-13	-2.5	-1.07E-08	-2	.94
	0.50718	25	3.18E-10	2.9	-1.73E-13	-2.3	–		.94

Source: Authors' calculations.

Appendix 4 Relevant Articles of the ECB Status

The following is from the Maastricht Treaty's *Protocol on the Statute of the European System of central banks and of the European Central Bank*. Emphasis has been added. Note that article 10.3 refers to decisions that affect the financial disposition of the ECB's (e.g. the Bank's capital).

Article 9: The European Central Bank

9.1 The ECB which, in accordance with Article 106(2) of this Treaty, shall have legal personality, shall enjoy in each of the member states the most extensive legal capacity accorded to legal persons under its law; it may, in particular, acquire or dispose of movable and immovable property and may be a party to legal proceedings.

9.2 The ECB shall ensure that the tasks conferred upon the ESCB under Article 105(2), (3) and (5) of this Treaty are implemented either by its own activities pursuant to this Statute or through the national central bank pursuant to Articles 12.1 and 14.

9.3 In accordance with Article 106(3) of this Treaty, the decision-making bodies of the ECB shall be the Governing Council and the Executive Board.

Article 10: The Governing Council

10.1 In accordance with Article 109a(1) of this Treaty, the Governing Council shall comprise the members of the Executive Board of the ECB and the governors of the national central banks.

10.2 Subject to Article 10.3, only members of the Governing Council present in person shall have the right to vote. By way of derogation from this rule, the Rules of Procedure referred to in Article 12.3 may lay down that members of the Governing Council may cast their vote by means of teleconferencing. These rules shall also provide that a member of the Governing Council who is prevented from voting for a prolonged period may appoint an alternate as a member of the Governing Council. *Subject to Articles 10.3 and 11.3, each member of the Governing Council shall have one vote. Save as otherwise provided for in this Statue, the Governing Council shall act by a simple majority. In the event of a tie the President shall have the casting vote*. In order for the Governing Council to vote, there shall be quorum of

two-thirds of the members. If the quorum is not met, the President may convene an extraordinary meeting at which decisions may be taken without regard to the quorum.

10.3   For any decisions to be taken under Articles 28, 29, 30, 32, 33 and 51, the votes in the Governing Council shall be weighted according to the national central banks' shares in the subscribed capital of the ECB. The weight of the votes of the members of the Executive Board shall be zero. A decision requiring a qualified majority shall be adopted if the votes cast in favour represent at least two-thirds of the subscribed capital of the ECB and represent at least half of the shareholders. If a governor is unable to be present, he may nominate an alternate to cast his weighted vote.

10.4   The proceedings of the meetings shall be confidential. The Governing Council may decide to make the outcome of its deliberations public.

10.5   The Governing Council shall meet at least ten times a year.

10.6   Article 10.2 may be amended by the Council meeting in the composition of the Heads of State or Government, acting unanimously either on a recommendation from the ECB and after consulting the European Parliament and the Commission, or on a recommendation from the Commission and after consulting the European Parliament and the ECB. The Council shall recommend such amendments to the Member States for adoption. These amendments shall enter into force after having been ratified by all the Member States in accordance with their respective constitutional requirements.

A recommendation made by the ECB under this paragraph (10.6) shall require a decision by the Governing Council acting unanimously.

Article 11: The Executive Board

11.1   In accordance with Article 109a(2)(a) of this Treaty, the Executive Board shall comprise the President, the Vice-President and four other members. The members shall perform their duties on a full-time basis. No member shall engage in any occupation, whether gainful or not, unless exemption is exceptionally granted by the Governing Council.

11.2   In accordance with Article 109a(2)(b) of this Treaty, the President, the Vice-President and the other Members of the Executive Board shall be appointed from among persons of recognized standing and professional experience in monetary or banking matters by common accord of the governments of the member states at the level of the Heads of State or of government, on a recommendation from the Council after it has consulted the European Parliament and the Governing Council. Their term of office shall be 8 years and shall not be renewable. Only nationals of member states may be members of the Executive Board.

11.3   The terms and conditions of employment of the members of the Executive Board, in particular their salaries, pensions and other social security benefits shall be the subject of contracts with the ECB and shall be fixed by the Governing Council on a proposal from a Committee comprising three members appointed by the Governing Council and three members

appointed by the Council. The members of the Executive Board shall not have the right to vote on matters referred to in this paragraph.

11.4 If a member of the Executive Board no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct, the Court of Justice may, on application by the Governing Council or the Executive Board, compulsorily retire him.

11.5 Each member of the Executive Board present in person shall have the right to vote and shall have, for that purpose, one vote. Save as otherwise provided, the Executive Board shall act by a simple majority of the votes cast. In the event of a tie, the President shall have the casting vote. The voting arrangements shall be specified in the Rules of Procedure referred to in Article 12.3.

11.6 The Executive Board shall be responsible for the current business of the ECB.

11.7 Any vacancy on the Executive Board shall be filled by the appointment of a new member in accordance with Article 11.2.

Article 12: Responsibilities of the decision-making bodies

12.1 The Governing Council shall adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the ESCB under this Treaty and this Statute. The Governing Council shall formulate the monetary policy of the Community including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB and shall establish the necessary guidelines for their implementation. The Executive Board shall implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council. In doing so the Executive Board shall give the necessary instructions to national central banks. *In addition the Executive Board may have certain powers delegated to it where the Governing Council so decides*. To the extent deemed possible and appropriate and without prejudice to the provisions of this Article, the ECB shall have recourse to the national central banks to carry out operations which form part of the tasks of the ESCB.

12.2 The Executive Board shall have the responsibility for the preparation of meetings of the Governing Council.

12.3 The Governing Council shall adopt Rules of Procedure which determine the internal organization of the ECB and its decision-making bodies.

12.4 The Governing Council shall exercise the advisory functions referred to in Article 4.

12.5 The Governing Council shall take the decisions referred to in Article 6.

Appendix 5 EU Legislating

This appendix draws heavily on the excellent web pages linked to the Parliament's fact sheets (http://www.europarl.eu.int/factsheets/default_en.htm).

A5.1 The actors

The *European Commission* is currently made up of one Commissioner from each EU member state with an extra Commissioner from the Big-5 (France, Germany, Italy, Spain and the United Kingdom). In practice, Commissioners are chosen by the member governments themselves (subject to the political agreement of other members); they should not accept or seek instruction from their native country governments. Generally, Commissioners are quite independent of their home governments, but since they have typically had high political roles in their home nations, they ensure that particular national sensitivities are heard at Commission deliberations.

The *Council of Ministers* consists of the relevant minister from each member state (agriculture ministers for agricultural matters, treasury ministers for tax issues, etc.). On issues taken on the basis of qualified majority voting, each Minister's vote is weighted, with more populous members having more votes (but the weight increases much less than proportionally with population). Currently, the total number of votes is 87 and the threshold for a winning majority (a 'qualified majority' in Euro-ese) is 62. This means that about 71% of all votes are required to adopt a proposal.

The *European Parliament* currently has 626 members (called MEPs) who are elected through a direct universal suffrage nation-by-nation. The number of MEPs per member varies with population, but as with Council votes, the number of MEPs per million EU citizens is much higher for large nations than for small. For example, Luxembourg has 6 MEPs and Germany has 99.

On relevant issues, the Economic and Social Committee and the Committee of the Regions are also consulted in the legislative process.

A5.2 Types of EU legislation

Apart from the Treaties, which are the primary source of EU law, five types of EU secondary law exist:

1. **Regulations** are the strongest form. They are binding and directly applicable in the EU member nations. National Parliaments do not need to adopt these; they already have the force of law in all member states.
2. **Directives** are the next in line. They set objectives that must be attained but leave it to members choose how to implement policies that attain the objectives.
3. **Decisions** also are quite strong in that they are directly binding on all those who are concerned by the regulation (e.g. a company or particular member) without first being adopted by the relevant national Parliament.
4. **Recommendations** can be formulated by the Council of the EU and/or by the European Commission. As the name suggests, they are not legally binding.
5. **Opinions** also are not legally binding. Indeed at the level of detail relevant here, recommendations and opinions are basically the same.

<u>A5.3</u> Procedures

The European Commission has a near monopoly on initiating the EU decision-making process and is in charge of formulating the exact shape of the proposed legislation, although naturally it consults widely with governmental and non-governmental bodies in the process. The next step typically is to present the proposal to the Council for approval. Under current practice, the vast majority of EU legislation also requires the European Parliament's approval, but the exact procedure depends upon the issue concerned. We turn now to the details of the four main procedures.

- **The cooperation procedure.** The cooperation procedure is really a minor footnote in EU legislating since it applies to only two aspects of the EMU. Basically, it is like the co-decision procedure (see below), but the European Parliament's amendment power is less explicit, and the Council can overrule a rejection from the European Parliament by voting unanimously.
- **The consultation procedure.** On some issues – e.g. agricultural price fixing – the European Parliament must give its opinion before the Council adopts a Commission proposal. Such opinions, when they have any influence, are intended to influence the Council, or the shape of the Commission's proposal.
- **The assent procedure.** On decisions concerning enlargement, international agreements, sanctioning member states and the coordination of the Structural Funds, the Parliament can veto, but cannot amend a proposal made by the Commission and adopted by the Council.
- **The co-decision procedure.** This procedure – which now covers most EU legislation passed (including those on the free movement of workers, creation of the single market, research and technological development, the environment, consumer protection, education, culture and public health) – gives the Parliament equal standing with the Council. That is, if the European Parliament (deciding by simple majority) and Council (deciding by qualified majority) agree with the Commission's proposal, the act is adopted. If they do not agree, the proposal is adopted only if a Council-Parliament compromise can be reached.

<u>A5.4</u> **The co-decision procedure in detail**

This starts with a Commission proposal. Next, Parliament gives its 'opinion', i.e. evaluates the proposal and suggests desired amendments, by simple majority. After seeing the Parliament's opinion, the Council adopts a 'common position' by a qualified majority, except in the fields of culture, freedom of movement, social security and coordination of the rules for carrying on a profession, which are subject to a unanimous vote. Then Parliament receives the Council's common position and has three months to take a decision. The act is adopted immediately, if Parliament expressly approves it or if it takes no action by the deadline. The process stops and the act is not adopted if an absolute majority of Parliament's Members rejects the common position. If a majority of MEPs adopts amendments to the common position, these are put to the Commission for its opinion and then returned to the Council. The Council votes by a qualified majority on Parliament's amendments; although it takes a unanimous vote to accept amendments that have been given a negative opinion by the Commission. The act is adopted if the Council approves all Parliament's amendments no later than three months after receiving them. Otherwise the Conciliation Committee is convened within six weeks.

The Conciliation Committee consists of an equal number of Council and Parliament representatives, assisted by the Commission. It considers the common position on the basis of Parliament's amendments and has six weeks to draft a joint text. The procedure stops and the act is not adopted unless the Committee approves a joint text by the deadline. If it does so, the joint text goes back to the Council and Parliament for approval. The Council and Parliament have six weeks to approve it. The Council acts by a qualified majority and Parliament by an absolute majority of the votes cast. The act is adopted if Council and Parliament approve the joint text. If either of the institutions has not approved it by the deadline the procedure stops and the act is not adopted.

Really rather simple, n'est-ce pas?

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Social Europe: One for All? MEI8 **(July 1988)**
Charles R Bean, Samuel Bentolila, Giuseppe Bertola and Juan José Dolado
MEI8 provides a detailed analysis of European labour markets, and sets out specific recommendations for the design and implementation of social policies within the EU. The Report addresses many of the issues raised in the debate surrounding the Social Chapter of the Maastricht Treaty.

EMU: Getting the Endgame Right. MEI7 **(March 1997)**
David Begg, Francesco Giavazzi, Jürgen von Hagen and Charles Wyplosz
The seventh MEI report argued that the final stage of the transition to EMU remained poorly understood; that many extant proposals had fatal flaws; and that finding a safer transition strategy was a matter of urgent priority. The authors suggested that it would be possible to preannounce bilateral conversion rates between the 'ins' and adopt wide bands during transition, thus offering a natural solution to the problems of the 'pre-ins'. This was the solution that was finally adopted by European policy-makers prior to EMU.

Flexible Integration: Towards a More Effective and Democratic Europe. MEI6 **(October 1995)**
Mathias Dewatripont, Francesco Giavazzi, Ian Harden, Torsten Persson, Gérard Roland, André Sapir, Guido Tabellini and Jürgen von Hagen
MEI6 was written to inform public opinion before the 1996 Intergovernmental Conference. The Report discusses a number of reforms including how to make the EU legal structure more flexible and transparent; how to improve enforcement of the Single Market; and how to make political decision-making more efficient and legitimate. Given the discussions in early 2000 about flexible integration, the Report remains highly topical.

Unemployment: Choices for Europe. MEI5 **(April 1995)**
George Alogoskoufis, Charles R Bean, Giuseppe Bertola, Daniel Cohen, Juan José Dolado and Gilles Saint-Paul
In the mid-90's high unemployment was widely regarded as the most important challenge facing European policy-makers. MEI5 analyses whether this resulted from an inability to understand the causes of the problem; a failure to find the economic policies to offer a solution; or simply from a lack of political will.

Making Sense of Subsidiarity: How Much Centralization for Europe? MEI4 **(November 1993)**
David Begg, Jacques Crémer, Jean-Pierre Danthine, Jeremy Edwards, Vittorio Grilli, Damien Neven, Paul Seabright, Hans-Werner Sinn, Anthony J Venables and Charles Wyplosz
In the fourth MEI report the authors contend that until detailed arguments for and against centralization are made the principle of subsidiarity remains an incomplete guide to decisions as to where power should reside.

Is Bigger Better? The Economics of EC Enlargement. MEI3 **(October 1992)**
Richard Baldwin, David Begg, Jean-Pierre Danthine, Vittorio Grilli, Jan I Haaland, Manfred J M Neumann, Victor D Norman, Anthony J Venables and L Alan Winters
The third MEI report examines the enlargement of the European Union to include the EFTA members and the Central and East European Countries (CEECs) and the implications of this for the Community's institutions

The Making of Monetary Union. MEI2 **(October 1991)**
David Begg, Pierre-André Chiappori, Francesco Giavazzi, Colin Mayer, Damien Neven, Luigi Spaventa, Xavier Vives and Charles Wyplosz
MEI2 examines the monetary unification of Europe and the creation of the European Central Bank, highlighting the possible conflicts between the ECB's responsibility for financial stability and its commitment to stable prices.

The Impact of Eastern Europe. MEI1 **(October 1990)**
David Begg, Jean-Pierre Danthine, Francesco Giavazzi, Carl B Hamilton, Damien Neven, Victor D Norman, André Sapir, Alasdair Smith, L Alan Winters and Charles Wyplosz
MEI1 was the first major study of how developments in Eastern Europe would affect the economies of Western Europe and the process of economic integration.

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