DISCUSSION PAPER SERIES

No. 2623

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INTERNATIONAL MACROECONOMICS, INTERNATIONAL TRADE AND TRANSITION ECONOMICS

Centre for Economic Policy Research

www.cepr.org

ISSN 0265-8003

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Discussion Paper No. 2623
November 2000

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CEPR Discussion Paper No. 2623

November 2000

ABSTRACT

EU Reforms for Tomorrow's Europe*

This paper contributes ideas and analysis to the ongoing EU reform debate. It consists of three distinct parts: voting in the Council of Ministers; restructuring the ECB's Governing Council; and the setting of enlargement 'examination' dates. The IGC currently focuses on Council voting, Commission composition, closer co-operation and the range of issued to be covered by qualified majority voting. Part 1 of the Paper evaluates Council voting reform proposals with quantitative tools from voting game theory. We find that only the 'dual simple majority' plan maintains decision-making efficiency and democratic legitimacy in an EU 27. We believe, however, that the impact of enlargement on the ECB's Governing Council also merits discussion in Nice. We demonstrate that an expanded Governing Council with its current structure would be unwieldy and plagued by decision-making difficulties that would prevent it from making hard choices at the right time. Financial markets could react negatively to the possibility of a dysfunctional ECB: the Nice summit should request the ECB to propose some solutions. Finally, we argue that undertaking these reforms before enlargement should be a priority, not a precondition. Specifically, the EU should now commit to firm accession 'exam' dates and signing dates (for those who pass). This should be done both for the earliest enlargement and for subsequent waves since this would stimulate incumbents and candidates to undertake the necessary reforms while ensuring that the first enlargement does not delay the second.

JEL Classification: D7, D71, E58, E61, F15, F36

Keywords: European Union, political economy, IGC, ECB, EMU, enlargement, accession, institutional reform, qualified majority voting

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* We would like to thank Daria Taglioni for her input and tireless research assistance, and Federica Sbergami for excellent editing.

Submitted 16 November 2000

NON-TECHNICAL SUMMARY

This paper contributes ideas and analysis to the ongoing EU reform debate. It consists of three distinct parts:

1. Voting in the Council of Ministers,
2. Reform of the ECB, and
3. Enlargement ‘examination’ dates.

The current IGC policy discussion now focuses on Council voting, Commission composition and the range of issued to be covered by qualified majority voting. Part 1 of this paper addresses the complex and contentious issues related to Council vote. We believe, however, that the impact of enlargement on EMU and the ECB, in particular, is of the utmost importance – so important that it merits discussion in Nice. Along similar lines, we argue that undertaking these reforms before enlargement should be a priority, not a precondition. The EU should now commit to firm accession ‘exam’ dates and signing dates (for those who pass). This should be done both for the earliest enlargement and for subsequent waves since this would stimulate incumbents and candidates to undertake the necessary reforms while ensuring that the first enlargement does not delay the second.

Part 1: Why Most Council Voting Reforms Will Not Work

EU reformers face a formidable challenge – construct an EU decision-making system that remains efficient and democratically legitimate even after the number of Member States nearly doubles. Toughest of all, the reform must be politically acceptable to each incumbent.

Do the proposed reform plans meet the efficiency, legitimacy and acceptability criteria? As it turns out, there are ways of quantitatively evaluating each proposal’s efficiency, legitimacy and acceptability. These numerical yardsticks are far from perfect – no measure of such elusive concepts can be – but they do suggest that most reform plans fail on democratic efficiency and/or legitimacy grounds.

Efficiency Measures and Findings

To gauge efficiency perfectly demands a 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. Absent this, we must look to imperfect measures. One approach speculates on issues and positions. How would Southern Member States vote on this and Northern ones on that? How would the ‘core’ react differently from the ‘periphery’? This is insufficient since if reformers do their job right, Council rule-making rules will apply for many years and to a vast range of issues (Charles de Gaulle was elected President in the year current EU decision-making rules took effect).

The Passage Probability

The admittedly imperfect efficiency measure we employ takes a radically different approach. It abandons all detail, embracing instead the Law of Large Numbers. Specifically, it measures how easy it would be to pass a randomly selected issue – random in the sense of Hegel's 'veil of ignorance' (none know their stance in advance). The measure, which comes from voting game theory, is called the 'passage probability'. This is how it works:

The computer calculates all possible coalitions among Members States (there are 32,768 in the EU15) and then determines how many of these are winning coalitions. Assuming that all coalitions are equally probable for a randomly chosen proposal, the ratio of winning coalitions to total coalitions provides a measure of efficiency. This depends in a complex way on the number of members, the vote distribution and, above all, 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. Moreover, no one can say what the optimal passage probability is; some like a difficult decision-making process, others not. The usefulness of this tool comes in showing how the various reforms and enlargements will *change* the current passage probability since this indicates whether a reform proposal maintains the EU's current level of decision-making efficiency.

The exact numbers are given in the paper, but the worst proposals on this score – the 'weighted dual majority' and the 'limited reweighting with population net' – cut the probability to a tenth of its current level. But the efficiency shortcomings of these two are obvious even without crunching the numbers – they basically just add ways of blocking proposals to the current system. Of the reweighting schemes, only the Italian plan avoids a standstill situation, but even with this, the passage probability in an EU27 is half its current level.

The dual simple majority (DSM) manages to maintain the current level of efficiency in an EU 27. Indeed, it raises it substantially. Moreover, the 50% majority rule displays a very special feature. Adding more members increases the number of winning coalitions at the same pace as it increases the number of blocking coalitions, so its passage probability is invariant to size. This would make DSM a long-lasting reform.

East/Poor Coalitions

We also gauge efficiency by focusing on the blocking power of two plausible alliances in the EU 27, an 'East Alliance' and a 'Poor Alliance' (Easterners plus the Cohesion-4). Our findings for this measure roughly confirm those of the passage probability. First, no reform, and three of the reform plans (Swedish reweighting, limited reweighting with demographic net and the weighted dual majority) present a serious risk of poor versus rich, or East versus West deadlocks. Second, under any of the five reform plans except the Italian reweighting scheme, the 'poor group' becomes a dominant political force in the EU27. Finally, regardless of which reweighting plan were adopted, the 'East group' alone has a comfortable blocking minority in the EU27 (but not in the EU20) under all scenarios except double simple majority and the Italian reweighting.

The message of these calculations should be clear. Reweighting alone cannot maintain the EU's ability to act with 27 members. Whether reweighting or double majority is adopted, efficiency can only be maintained if the 71% threshold is lowered.

Legitimacy and the Reweighting Dilemma

The EU is a Union of States, and the EU is a Union of People. If it were only one, legitimacy would be straightforward – or at least as straightforward as anything is when it comes to voting. The traditional Union-of-People rule is one-person-one-vote (proportional representation). In a Union of States, it is one-nation-one vote (intergovernmentalism). These extremes are tremendously handy intellectual landmarks since they spotlight the inescapable 'legitimacy dilemma' facing the pure reweighting proposals.

As a matter of pure logic, shifting the current vote allocation in favour of big nations pushes the system towards proportional representation, but away from intergovernmentalism. This makes the system more Union-of-People legitimate, but less Union-of-States legitimate. Whether it was pure genius, or dumb luck, the current weighting scheme avoided this dilemma because the historical size-profile of EU membership was sufficiently compressed to allow one rule to satisfy two legitimacy criteria. Enlargement, however, will greatly skew the size profile and this squeezes the EU into a dilemma.

The dual majority plans resolve the dilemma by, in essence, allowing the EU to move its threshold in two directions at once, setting one Union-of-People threshold and one Union-of-States threshold. As usual, one needs two parameters to meet two goals.

Of the dual majority plans, the simple dual majority is the purest in terms of the 2-Unions perspective. The dual majorities with weighted Council votes and population muddy the issues since Council vote weighting is itself an attempt to combine Union-of-States legitimacy with Union-of-People legitimacy.

Power Shifting and Political Acceptability

The distribution of political power is the key to political acceptability, so a yardstick of power is needed. Indeed, implicitly or explicitly, reformers will apply one to each proposal on the table. The power measure we use is again based on the Law of Large Numbers. Specifically our preferred measure – the normalized Banzhaf index (NBI) – gauges how likely it is that a nation could 'break' a winning coalition on a randomly selected issue.

Application of this admittedly imperfect measure confirms that re-weighting is pro-Big Members but it also shows that the dual simple majority rule is pro-Small. This was not obvious before doing the numbers since the dual simple majority plan shifts voting weights in two conflicting directions. By giving nations one-vote each on the membership threshold, the plan increases the weight of small nations compared to the status quo (Germany and Luxembourg get one vote, instead of 10 and 2 respectively), but it shifts weight to big nations on the demographic threshold.

And the Winner Is …

Overall, our numbers point to the dual simple majority as the only plan that clears the bar on both efficiency and legitimacy grounds. Weighted voting schemes do not work (to paraphrase Banzhaf) since to make them efficient (by lowering the threshold) is to make them unfair (in terms of Union-of-People legitimacy, i.e. the minimum population share in qualified majority).

Part 2: ECB Restructuring before EU Enlargement

ECB restructuring should be on the agenda since enlarging the European Central Bank (ECB) with its existing structure would be dangerous. Adding 5 or 12 new members to the Governing Council as it stands would make a big, unwieldy group. The most optimistic scenario would then be an ECB plagued by decision-making difficulties of the type that usually favour the *status quo*. Such an ECB would fail on the main task of a Central Bank – making hard choices at the right time. A listless ECB would not be a good steward of Euroland's economy, and its slender popular support would evaporate if it repeatedly sat on interest rates while inflation picked up or the Euro economy dived.

But the outcome might not be this rosy.

In one scary, though perhaps improbable, outcome, a 30-strong Governing Council would divide into a large number of 'Irelands' and a handful of 'core' nations, with the 'Irelands' having enough votes to set interest rates while accounting for only 20% of Euroland output.

These are urgent problems. Financial markets, for example, are forward looking and thus need no more than the *possibility* of a dysfunctional ECB to react negatively. Since structural changes will just get harder post-enlargement, EU leaders should start now, by requesting the ECB to formulate some solutions.

EMU Expansion in 1 June 2005?

Here is the standard thinking on the timing. The Treaty speaks of a 2-year reporting period before any EMU convergence evaluation. Combining this with a 3-month data gathering/report writing/deliberation lag, and a 6-months transition period for euro-adoption, implies a 33-month minimum gap between EU and EMU enlargements – if the rules are followed. In any case, it is claimed, few newcomers will qualify at so early a date.

Here is the reality. The convergence evaluation is a political decision taken by the Council of Ministers (Ecofin), so the delay between EU and EMU accessions will be politically determined. After almost a decade of viewing them as supplicants, it is easy to forget that the newcomers will have – on the Council – full rights, including veto power over unanimous Council decisions. Historically, such power was used to bend EMU entry rules (of the euro-12, only two met all of the numerical Maastricht criteria to the letter). Surely, such power will lead to future rule stretching.

If the Central and Eastern European Countries (CEECs) feel as strongly about EMU membership as they do now, and they have made robust efforts to meet the criteria, the political pressure to let them in will be irresistible. In short, one cannot count on a long delay between EU accession and EMU accession; if accession occurs 1 January 2004, EMU expansion is a possibility in late 2005 for the best-prepared entrants.

We can be more specific. The longest formal delays are the 2-year-in-ERM rule and the euro-adoption transition period. Given the 'Italian precedent' (Italy got in on a 15-month ERM track record) it will be politically impracticable to hold newcomers, such as Estonia, to 2-years. And once an exception is made for Estonia, how can the others be denied? The euro-adoption lag (8 months for founding members, 6 months for Greece) will also be shorter since some newcomers may already be largely or fully euro-ised. On making the Maastricht numbers, we note that many CEECs are in better shape now than the incumbent EMUers were five years before their entry. And remember, these are nations with much practice in adopting harsh reforms to attain cherished goals.

Decision-Making in a Big ECB with Unchanged Structure

We illustrate the decision-making difficulties with several examples. Here is one. In practice, the ECB President proposes an interest rate change and must get half the votes to win. In January there will be 18 votes, one for each of the 6 Executive Board members and 12 Central Bank governors. If the Executive Board acts in unison, it is now quite powerful relative to the Central Bankers since it needs only 3 allies to get its way (the President breaks ties). This strength is magnified by the relative homogeneity of the EMU group. The point is that the euro-core nations make up most of the euro economy, so their national inflation rates are arithmetically close to the target the Board is supposed to follow. Thus, even if the core-7 were to vote with purely nationalistic perspectives, they would typically find themselves close to the Board's position.

This situation is beneficial since first-rate monetary policy needs strong leadership. Letting in more members gravely weakens the Board's relative power. Adding just 5 morenational central bank governors doubles the required number of Board-allies from 3 to 6. With 12 newcomers, the figure almost triples (3 to 11). Furthermore, the newcomers are likely to be high-growth nations with a substantial inflation differential stemming from structural sources (Balassa-Samuelson effect). This may make them more hawkish, but the point is that their national perspectives will systematically differ from those of the core-7. Plainly, the ECB must be restructured before it is enlarged.

Restructure and then Enlarge

The necessary changes should take place before the next EU enlargement since the just-minted EU members will view them as a retraction of hard-won powers. Since such measures require a Treaty revision, they will have a veto over it. This increases the difficulty of agreeing any reform. More worrying is the fact that one very natural ‘price’ for the CEEC assent would be a lenient judgement on the Maastricht criteria and timetable (‘you can reform it, if we can join it’). The idea that EMU membership was being traded for agreement on reform would raise doubts. And doubt is all that is needed to trigger negative reactions in financial markets.

The Paper details some of our thoughts on solutions, but our main message is a call to action. ECB restructuring will be necessary and it will be much harder post-enlargement. The EU should start thinking about it now.

Part 3: Enlargement ‘Examination’ Dates

Simple political logic tells us that some institutional reform must be accomplished before enlargement. We have added the ECB to Commission and Council reform. To cynics, lengthening this reform-before-enlargement list is an enlargement-delaying stratagem. More importantly, making further EU internal reform a *condition* for enlargement gravely undermines the CEECs’ transition process, which in turn could damage the harmony of the eventually enlarged Union.

There is, however, an uncomplicated way to reconcile the ‘reform imperative’ and the ‘accession imperative’. *The EU should make reform a priority rather than a precondition.*

Practically, this could be accomplished by a firm commitment to dates – not accession dates, but Maastricht-style dates that lock in:

1. The first date for evaluating which nations are ready to join
2. The date for signing accession Treaties with those who passed the evaluation
3. The dates of subsequent evaluations and signatures

Knowing the timeline, incumbent Member States would, before the first date, reform all that was truly necessary. Such dates would therefore spur both EU and CEEC reform efforts. Locking in subsequent dates would clarify the situation for second-wavers and distant aspirants, by removing the distinct possibility the first enlargement will significantly delay the second.

The date issue is complex, so a framework for organizing our thoughts is useful. 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 impose 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 MD
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.
Lessons can also be garnered from the Maastricht Treaties dates. The first is that Maastricht set dates for evaluation as well as entry. The first evaluation date, 31 December 1996, provided weak reform incentives because of its nature – it was what could be called the 'only-if-enough-are-ready' date. (This is like announcing that the MD exam will be on Monday only if enough students study over the weekend.) The second Maastricht evaluation date, 31 December 1997, 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 (although 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. Any aspiring doctor would be distraught at the possibility that his exam might 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.

Synthesis

The Union must reform before it enlarges. Many reform items are on the agenda and we provide some numbers that shed new light on the one most contentious issue – voting weights in the Council of Ministers. There are, however, other reforms not on the agenda that must also be undertaken before enlargement and will also require Treaty changes. The most important one by far is ECB restructuring. To avoid the damaging impression that lengthening the reform agenda is a ruse to delay enlargement, and to provide incumbents with an incentive to finish the reforms that are truly necessary before enlargement, the EU should set dates. These should specify 'exam' and 'signature' dates, not accession dates.

EU Reforms for Tomorrow's Europe

Table of Figures and Boxes

PART 1

IGC Voting Reforms: Some Numbers Showing Why Most Will Not Work

1. The Challenge

Eastern enlargement will alter the distribution of power in the European Union and this in turn will have important, maybe even dramatic, implications for EU decision-making.

Democratic legitimacy is the first concern. Under current rule-making rules, small members have many more Council-votes power than their populations would suggest. While this overweighting was intentional in 1958, it cannot work in a Union with a handful of big members and over twenty small ones. Decision-making efficiency is the second concern. Adding 12 or 13 new members will inevitably slow down decision making, especially since the applicants are economically quite different from the incumbents and likely to remain so for decades.

These concerns confront negotiators at Nice with a formidable project – construct an EU decision-making system that remains efficient and democratically legitimate even after the number of Member States nearly doubles. Toughest of all, the reforms must be politically acceptable to each incumbent Member State.

Several reform plans have been proposed, but do they meet the efficiency, legitimacy and acceptability criteria? As it turns out, there are ways of quantitatively evaluating each proposal's efficiency, legitimacy and acceptability. These numerical yardsticks are far from perfect – no measure of such elusive concepts can be – but they do suggest that most reform plans fail on democratic efficiency and/or legitimacy grounds. Before defining and applying these 'evaluation tools', we briefly present the main reform proposals being considered at the IGC.

2. Reform Proposals on the Table

The Council reform proposals on the table come in two flavours: reweighting and double majority.[1] Several variants of reweighting have been mooted during the IGC– all of which seek to increase the vote shares of big nations. The two variants still in contention are the so-called Italian and Swedish proposals. The Italian proposal involves a large increase in big nation votes relative to those of small nations. The Big-4, for instance, would get 3.3 times more votes than they have now while Luxembourg would get only 0.5 times more. The

[1] This is based on the IGC Working Document, CONFER 4796/00 (9/11/00) and the Portuguese Presidency's June 2000 Report on the IGC progress (CONFER 4750/00 and especially the annexes).

Swedish proposal would give nations twice the square root of their population measured in millions. This may sound wacky – fantastically specific without any apparent guiding principle – but in fact the square root rule has a cherished position in the 'science of voting' (more on this below). The square root rule awards many more votes to the Big-5 and so it can also be viewed as compensation for Commissioners lost. The exact allocations of votes under these reweighting formulations are shown at the end of the section (Table 5).

Reforms based on the double majority principle also come with several options. The Commission's version – called double simple majority (DSM) – requires that at least 50% of Member States vote 'yes' and that these yes-voters speak for at least 50% of the EU populace. Slight variants on this stay with the dual majority in terms of nations and people, but suggest different thresholds, such as 50% of nations and 60% of population, 60% of both, or 71% of both. There are also two very different dual majority proposals, known as 'weighted double majority', and 'limited reweighting with a population safety net'. These also set two majority thresholds, but the thresholds are in terms of weighted Council of Minister votes and population. The simplest (and least sensible, as we shall see) maintains status quo qualified majority voting procedures in the Council, including the current vote weights and 71% majority threshold, but adds on an additional barrier that the nations in any qualified majority must represent at least 58% of the EU population. The second – what we call the 'limited double majority' plan – follows the same basic principles but proposes to reweight the Council votes slightly in favour of large nations. Specifically, all members would get twice their current votes (to reduce the problem of in-between-size newcomers) and the Big-5 would get 5 extra votes in exchange for the loss of their second Commissioner.

3. Evaluation of Reform Proposals

The reforms proposed all aspire to improve EU decision-making efficiency while maintaining its legitimacy and political acceptability. This subsection introduces and then applies a number of 'measuring tools' that help gauge whether the reforms would do all they claim (as we shall see, they do not). The tools also help clarify the differences among the reform proposals. The next 3 subsections cover efficiency, legitimacy and acceptability in that order.

3.1. Efficiency of Reforms: Measuring the Un-measurable

If current rules remain unchanged and twelve nations join, EU decision-making will probably cease to function. This point is widely acknowledged, so the prime goal of each reform is to allow the Union to act even after expanding the club. How, however, should one judge whether a reform will increase decision-making efficiency sufficiently?

To do it correctly, 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, negotiators may still be tempted to evaluate proposals based on speculation about issues and positions. How would the 'garlic belt' vote on this, and the 'northern fringe' on that? As well as being difficult, the results of such exercises are arbitrary since reasonable people can differ over the forecasted issues and positions. Evaluations based on speculation and conjecture on issues and positions are therefore insufficient.

Our admittedly imperfect efficiency measure sounds radical at first since it abandons all detail, embracing 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 with just 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 a brand of toothpaste in a particular market requires more than prices and incomes. But when aggregating across a few products, the simplifying magic of the Law of Large Numbers works wonders. Branding and sales forces become random shocks that wash out of the aggregate. 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 'garlic belt' would not have a blocking minority 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

As usual, a good starting point is to define the thing carefully, since 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 handy artifice of the Law of Large Numbers, i.e., by focusing on how difficult it would be to approve a randomly selected issue. In fact, this focus produces a precise, if imperfect, measure of efficiency, the 'passage probability'. Here is how it works.

The Passage Probability

The computer calculates all possible coalitions among Members 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 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'. It is affected by the number of members, the distribution of votes and, above all, by the majority rule.

Of course, the exact *level* of the passage probability is almost entirely useless since the Commission only proposes things it thinks will pass. Moreover, no one can say what the optimal passage probability is; some like a difficult decision-making process, others not. The usefulness of this tool comes in showing how the various reforms and enlargements will *change* the current passage probability. In particular, the change indicates whether a reform proposal increases or decreases the ease of EU's decision making.

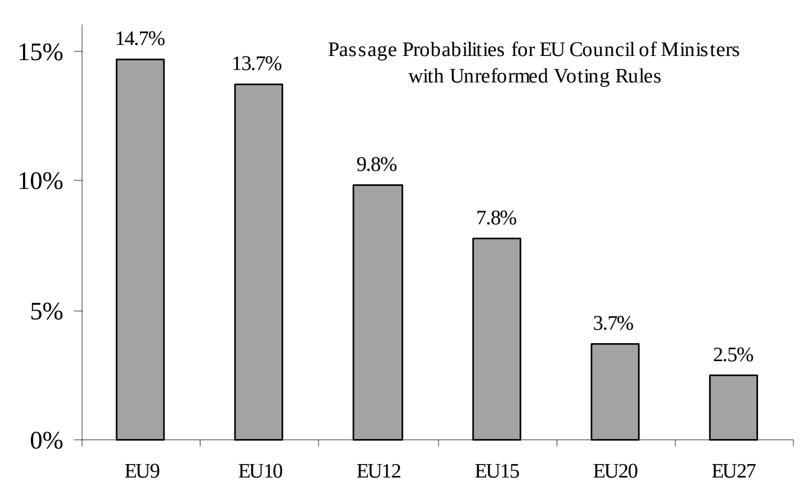
The Passage Probability's Historical Track Record

Before applying this tool to the reform plans, it is useful to 'test' it out on historical EU configurations. The four leftmost bars in Figure 1 show the 'passage probability' for the EU9, EU10, EU12 and EU15. 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 most remarkable fact in is that letting in even 5 newcomers reduces efficiency much more than letting in 3 EFTAns did. Specifically, the first 5 new members would halve the likelihood of passing a randomly selected proposal (from 7.8% to 3.7%). The explanation is simple. Expanding membership increases the number of ways to form a 30% blocking coalition much more rapidly than it increases the number of ways to form a 71% winning coalition, and 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, the first wave will be like letting in another Spain, two more Greeces and a Denmark; common sense tells us that decision-making is bound to get much more burdensome. The passage probability quantifies this common sense.

Further enlargement to 27 members also has a massive effect, reducing the passage probability to a third of its current level (Kirman and Widgren (1995)).

Figure 1: Passage probabilities, past (EU9-EU15) and future (EU20-EU27)



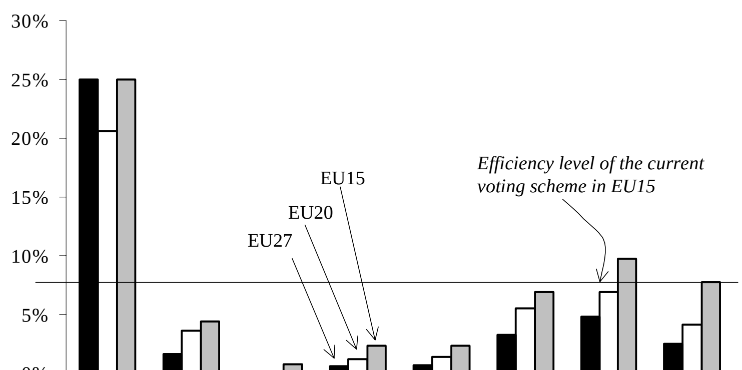
Note: The future enlargements envisaged are the EU20 (EU15 plus Czech Republic, Estonia, Hungary, Poland and Slovenia), and the EU27 (EU 20 plus the other CEEC applicants, Cyprus and Malta); Turkey never enters our calculation since its accession seems a distant challenge to the system.

Efficiency of the Proposals

Figure 2 applies the tool to the 5 main reform proposals. The numbers give the probabilities of passing a randomly selected issue in the Council under alternative voting schemes. This chart clearly demonstrates that the two reweighting plans fail on the efficiency criteria in that they will not maintain the current level of decision-making ease in a Council of 27. If the square root or Italian proposals were applied to the EU15, decision-making would be little changed. However, under either reform the passage probability drops precipitously with the addition of newcomers with the square root rule performing worse than the Italian proposal. Indeed, the passage probabilities in the EU27 with square root weighting does only marginally better than the status quo rules. The Italian proposal implies a 50% reduction in efficiency (from 9.7 to 4.8).

The chart also shows that the 'double simple majority' reform is clearly superior in terms of efficiency. Its application to the EU15 would, for example, result in a radical increase in the ease of passing propositions in the Council of Ministers (from 8% to about 25%).[2] The reason for this has little to do with the dual majority principle. It is mainly due to the lower threshold. This point is made clear by a comparison of double majority under 50%, 60% and 71% thresholds. In the EU27, the corresponding passage probabilities are 25%, 1.6% and 0.1%. Notice that this latter figure, 0.1%, justifies the widespread perception that double majority with no change in the current threshold would freeze decision-making in the Council.

Figure 2: Efficiency of proposed reforms



	Dual 50%	Dual 60%	Dual 71%	Wtd Dual	Limited dual	Square Root	Italian	No reform
■ EU27	25.0%	1.6%	0.1%	0.6%	0.7%	3.3%	4.8%	2.5%
□ EU20	20.6%	3.6%	0.2%	1.2%	1.4%	5.5%	6.9%	4.1%
▨ EU15	25.0%	4.4%	0.8%	2.3%	2.3%	6.9%	9.7%	7.8%

Notes: The figures show the "passage probability" which measures the likelihood that a randomly selected issue would pass in the Council of Ministers.
Definitions:
Dual 50% = Dual simple majority (Commission proposal), Dual 60% and 71% are variants presented for comparison and to illustrate impact of the threshold on efficiency.
Wtd Dual Maj. = "Weighted" Dual majority.
Square Root = Swedish proposal, also known as "generalised" reweighting.
No Reform = Votes extended to newcomers as under current system.
Limited dual.Maj. = "Limited" reweighting with population safety net.
Italian = "Substantial" reweighting.
Source: Authors' calculations (evaluation.xls)

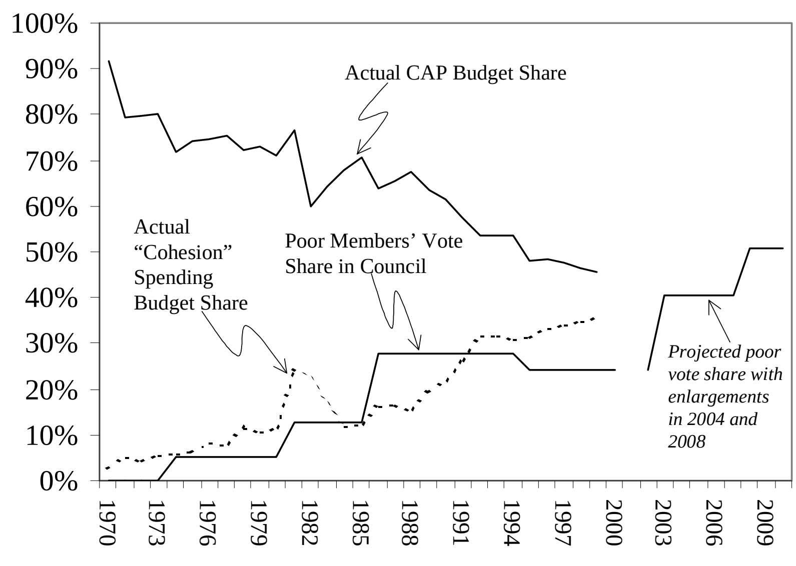
[2] The probability dip for the EU20 stems from difficulties that arise with an even number of nations and a 50%

In terms of Council's capacity to act, the next worst alternatives (after dual 71%) are the weighed dual majority plan and the dual majority with limited reweighting plan. The reason for the low passage probabilities is plain and really requires no calculation. As far as efficiency is concerned, the weighted dual scheme is an unambiguous increase in the number of ways a proposal can be blocked. That is, a proposal can be blocked as it can now under the qualified majority voting rules in the Council and it can be blocked on demographic grounds. Plainly, then, this proposal just worsens the problem of effective decision making in the enlarged EU. The same applies the to 'limited' dual majority system since the reweighting has little impact on efficiency of weighted Council voting. As the chart shows, limited reweighting with a single majority required results in a sharp drop in the passage probability post-enlargement. Adding a second barrier to the first would lower the passage probability even further.

To summarise, only the dual simple majority scheme maintains the EU's ability to act. Moreover, the 50% majority rule displays a very special feature. With a 50% threshold, enlarging the number of voters increases the number of winning coalitions at the same pace and it increases the number of blocking coalitions. The dual simple majority plan thus constitutes a long lasting reform in that it could accommodate further enlargements. This is convenient since eventually many more nations will probably become members, for example, Turkey, Croatia, Albania, and the 2 or 3 other Balkan states, not to mention nations further east.

Our second efficiency-measuring tool, to which we turn next, confirms these findings.

Box 1: Poor members and spending on poor regions, 1970-99



Until Greece joined in 1981, the EU had no poor members and, not surprisingly, it spent little on poor regions. As the power of poor members rose – measured in this case simply by voting share – EU budget priorities shifted toward Structural and Cohesion spending. Interestingly, poor region's share of Council votes more or less equals the budget share devoted to poor regions. This is how it worked in the past and how it is like to work in the future. This increased spending was financed by a combination of higher contributions by incumbents and CAP reform.
Source: Authors' calculations (evaluation.xls)

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rule (this is why many decision-making bodies avoid even numbers of decision-makers).

Cohesion versus CAP: East/Poor Blocking Coalitions

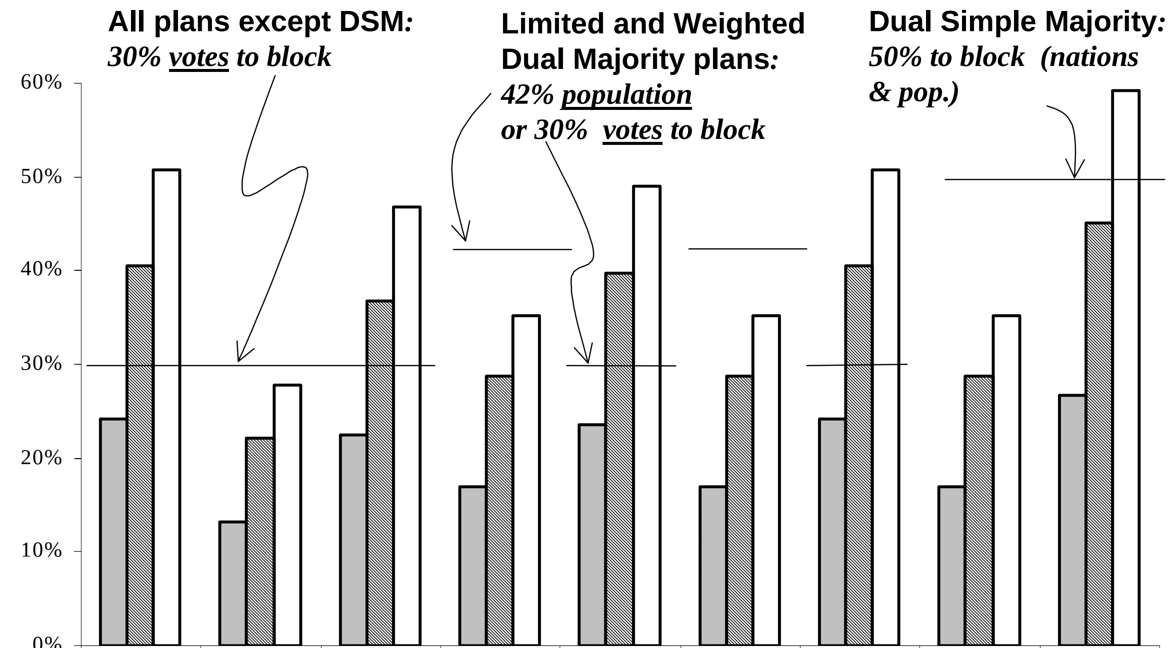
On most issues, the newcomers are just as likely to disagree with each other as they are to disagree with incumbents. However on certain issues – issues that have already shown themselves in the accession talks – they are likely to have similar views. It is therefore of some interest to see if an alliance 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 (see Box 1). It seems possible, therefore, that the poor newcomers will team up with the incumbent poor-4 to get CAP cash. They will, after all, be backed by the potent pair of cohesion's moral force and lots of Council votes. Who knows, maybe this would take the form of a 'Solidarity Fund' to complement the Cohesion Fund? This suggests that it is important to consider a blocking minority made up of the incumbent poor-4 (Spain, Portugal, Ireland and Greece) and the newcomers who are all poor by EU15 standards.

The Numbers

Figure 3 shows the numbers on the 'Poor Alliance' for the EU15, EU20 and EU27 under the various reform schemes. Each reweighting scheme has a single set of three bars. For example, the first set shows the figures for the no-reform scenario, with the first bar illustrating the fact that the poor-4 currently have 24.1% of Council votes. As the EU expands by 5 and then 7 members, this would increase to 40.5% and 50.7%. For convenience, a horizontal line is drawn in at 30%, which is the vote share necessary to block under current rules. What clearly emerges from this first set of bars is the strong possibility of debilitating poor-versus-rich, or CAP-versus-cohesion deadlocks in the Council.

Figure 3: Poor Nations' Blocking Power with the Reforms Proposals

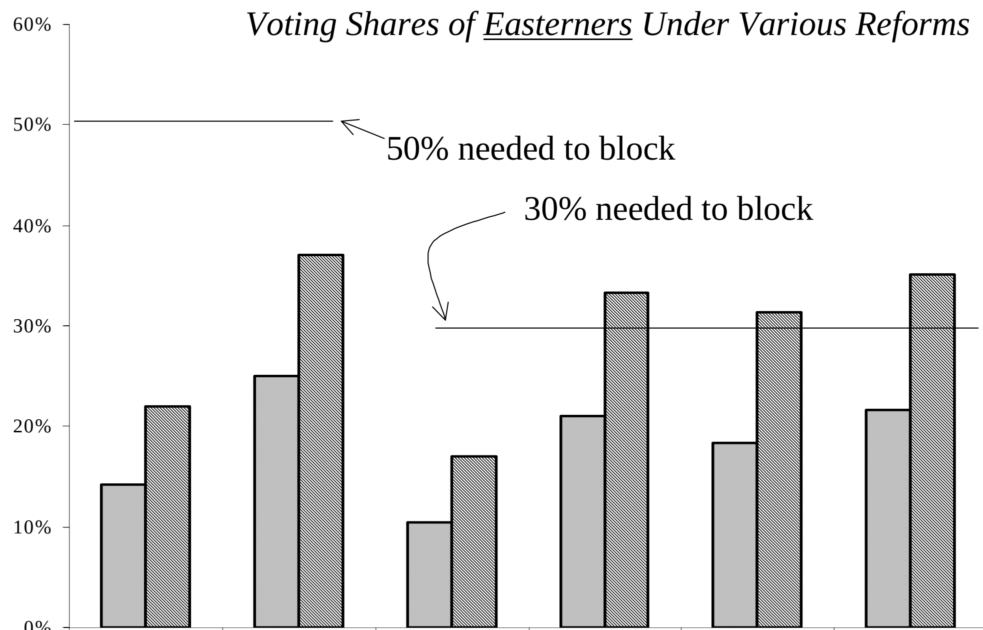


	No Reform (votes)	Italian (votes)	Swedish (votes)	Limited dual (pop.)	Limited dual (votes)	Weighted dual (pop.)	Weighted dual (votes)	DSM (pop.)	DSM (nations)
EU15	24.1%	13.1%	22.5%	17.0%	23.6%	17.0%	24.1%	17.0%	26.7%
EU20	40.5%	22.2%	36.7%	28.8%	39.7%	28.8%	40.5%	28.8%	45.0%
EU27	50.7%	27.9%	46.8%	35.2%	49.0%	35.2%	50.7%	35.2%	59.3%

Notes: The numbers show -- for the various reform proposals -- the total vote (population) share of "poor" Member States in the EU14 (the poor-4: E, P, IRL, GR), the EU20 (the poor-4+CZR,EST,H,PL,SLV) and an EU27 (ditto+LAT,LIT,BG,RO,SLK).
Definitions (for exact vote allocation see Web Appendix 1):
No Reform = Votes extended to newcomers as under current system.
Italian = "Substantial" reweighting.
Swedish = Swedish 'square root' proposal, also known as "generalised" reweighting.
Limited dual = Limited dual majority, 71% of votes with reweighting and 58% of population to pass.
Weighted dual = status quo vote allocation with 71% threshold plus 58% of population to pass.
DSM = Double Simple Majority (Commission proposal), 50% of population and nations to pass.
Source: Authors' calculations (evaluation.xls)

The second and third sets of bars show similar figures for the Italian and Swedish reweighting schemes. The Swedish proposal suffers from the same threat to efficiency (it grants the poor alliance a strong blocking minority), but the Italian proposal avoids this by drastically reducing the power of small nations (and only two of the 16 poor nations in the EU27 will be large). While it avoids such deadlocks, we shall see that this radical shift comes up short along the legitimacy and political acceptability dimensions.

Figure 4: Easterners' Blocking Power with the Reforms Proposals



	DSM (pop.)	DSM (members)	Italian	Limited	Swedish	No Reform
EU20	14.3%	25.0%	10.5%	21.0%	18.4%	21.6%
EU27	22.0%	37.0%	17.0%	33.2%	31.4%	35.1%

Notes: The numbers show -- for the various reform proposals -- the total vote share of Central and Eastern European Member States in an EU20 (EU15+CZR,EST,H,PL,SLV) and an EU27 (EU20+LAT,LIT,BG,RO,SLK).
Definitions: Double 50% = Double Simple Majority (Commission proposal),
DSM = Double Simple Majority (Commission proposal), 50% of population and nations to pass.
Italian = "Substantial" reweighting.
Limited = Limited 71% of votes with reweighting (NB: Eastern population shares as in DSM)
Swedish = Swedish 'square root' proposal, also known as "generalised" reweighting.
No Reform = Votes extended to newcomers as under current system.
NB: Numbers for "Weighted dual majority" are identical to no-reform on votes and DSM on population.
Source: Authors' calculations (evaluation.xls)

The remaining six sets of bars show the numbers for the three dual majority proposals. For example, the fourth set of bars indicates the poor alliance's population-share in the EU15, EU20 and EU27 (obviously these are identical for all dual majority schemes). Note that with a 58% majority rule on population (i.e. 42% to block), the poor group will not have enough people to block on the demographic threshold. They will, however, have enough on the Council vote threshold. The fifth set of bars illustrates the vote share under the limited reweighting suggestion. What the fourth and fifth set show is that the limited reweighting would do little to avoid the deadlock-possibility in an enlarged EU since the poor alliance would have almost 50% of the votes in the EU27 and almost 40% of in the EU20. The next two sets show the numbers for the weighted-dual-majority plan. This suffers from exactly the same problems since this plan combines the no-reform option with a population threshold. This does nothing to limit the power of the many small, poor nations that will be members of the EU27.

The leftmost bars show the numbers for the double simple majority (DSM) plan. This plan does a much better job of avoiding deadlock. Only in the EU27 does the possibility of poor-versus-rich deadlock arise. Specifically, in the EU27, the newcomers plus the incumbent poor-4 would have less than half the EU population, but they could form a blocking coalition based on the number of members, being 16 of the 27 members. Nevertheless, this is probably less of a problem than the raw numbers suggest. Some of these 16 (Ireland and maybe Spain and Slovenia) are likely to be classed as rich before the membership reaches 27, so a poor alliance is unlikely to have a blocking coalition when the time comes. Moreover, many of these 16 will be or are both pro-CAP and pro-Structural Funds, and so may be reluctant members of a coalition that aims to shift spending priorities from the former to the latter. This same proviso applies to the other schemes, but note that the size of the poor coalition is much further above the blocking level for the other schemes (apart form the Italian proposal). Although they are not shown, it should be clear that double majority plans involving higher thresholds are much more likely to allow a poor coalition to block since they involve lower majority thresholds.

Figure 4 illustrates the same sort of numbers for a hypothetical alignment of all CEEC members. It is important that an Eastern alliance would have blocking power in the EU27 under all the schemes except the Italian plan and double simple majority.

To summarise, there are two salient facts in Figure 3 and Figure 4. First, no-reform, and three of the reform plans – Swedish reweighting, limited reweighting with demographic net, and the weighted dual majority – raise a serious risk of poor-versus-rich, or East-versus-West deadlock situations. Second, under any of the five reform plans except the Italian reweighting scheme, the ‘poor group’ becomes a dominant political force in the EU27 with about 50% of the Council votes under either no-reform or the Swedish reform. Finally, regardless of which reweighting plan were adopted, the ‘East group’ alone has a comfortable blocking minority in the EU27 (but not in the EU20) under all scenarios except double simple majority and the Italian reweighting.

Overall this alternate measure of efficiency confirms the three main finding from the passage probability analysis.

1. Except for the Italian plan, reweighting schemes with unchanged majority thresholds fail to preserve the Council’s ability to act. Improving the efficiency of reweighting scheme beyond this, Widgren (1996) argues, would require a power shift so massive as to make it politically unacceptable
2. The dual 50% majority does maintain efficient decision making.
3. Other double majority plans are much more likely to allow east/poor coalitions to block since they involve lower majority thresholds.

Conclusion #1: Lower the Threshold

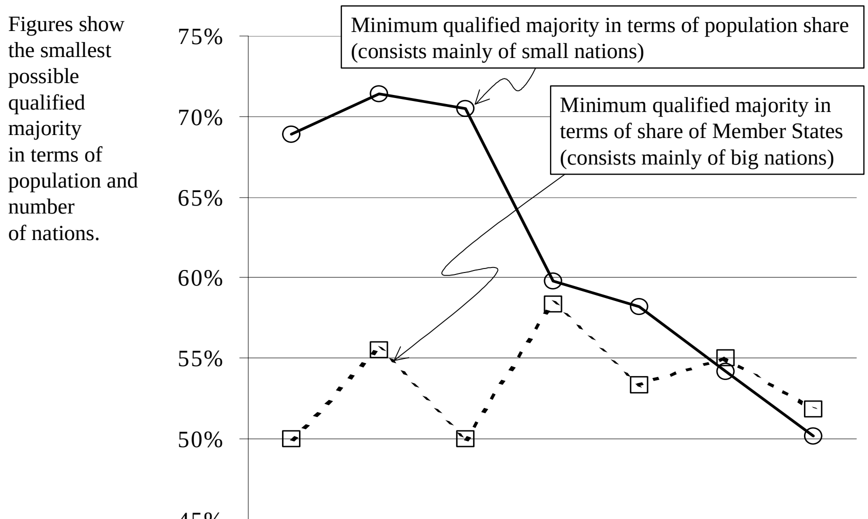
The message of these calculations should be clear. Whether reweighting or double majority is adopted, the current threshold of 71% should be lowered to maintain the Council’s ability to act. Of course, these figures do not mean that total deadlock is a surety. On certain clear-cut issues, the Council will be able to act under any rule, even unanimity. Yet when reforming a voting system for the long run, averages are what matter. Our calculations show that the average outcome is quite bad for any reform that maintains the majority rule at 71%.

Legitimacy is the next aspect to evaluate.

3.2. Legitimacy of Proposed Reforms

The EU is a union of states, and the EU is a union of people. If it were only one, legitimacy would be straightforward – or at least as straightforward as anything is when it comes to voting. Although the world knows many exceptions, the traditional Union-of-People rule is one-person-one-vote, i.e. proportional representation; in a Union of States, it is one-nation-one vote. These 2 extremes – proportional representation (Union of People) and intergovernmentalism (Union of States) – are tremendously handy intellectual landmarks. Any conceivable EU decision-making procedure can be represented as a blend of the two (see Web Appendix 2 for details- the appendices to this section are too bulky to include; they are posted on http://hei.unige.ch/~baldwin/).

Figure 5: Minimum Qualified Majorities with No Reform, EU6-EU27



	EC6	EC9	EC10	EC12	EC15	EU20	EU27
Min. Pop. 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:
See previous figures for definitions of EU20 and EU27.
The solid-line 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 minimise 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.
Source: Authors’ calculations (evaluation.xls).

Moreover, these landmarks spotlight the inescapable ‘legitimacy dilemma’ facing the pure reweighting proposals. As a matter of pure logic, shifting the current vote allocation in favour of big nations pushes the system towards proportional representation, but away from intergovernmentalism. This makes the system more Union-of-People legitimate, but less Union-of-States legitimate. Whether it was pure genius, or dumb luck, the current weighting scheme avoided this dilemma because the historical size-profile of EU members was sufficiently compressed to allow one rule to satisfy two legitimacy criteria. Enlargement, however, will greatly skew the size profile and this squeezes the EU into a dilemma.

The dual majority plans directly solve the legitimacy dilemma by setting one Union-of-People threshold and one Union-of-States threshold. As usual, one needs two parameters to meet two goals, unless one is as lucky as the sages who set up the current system in 1958.

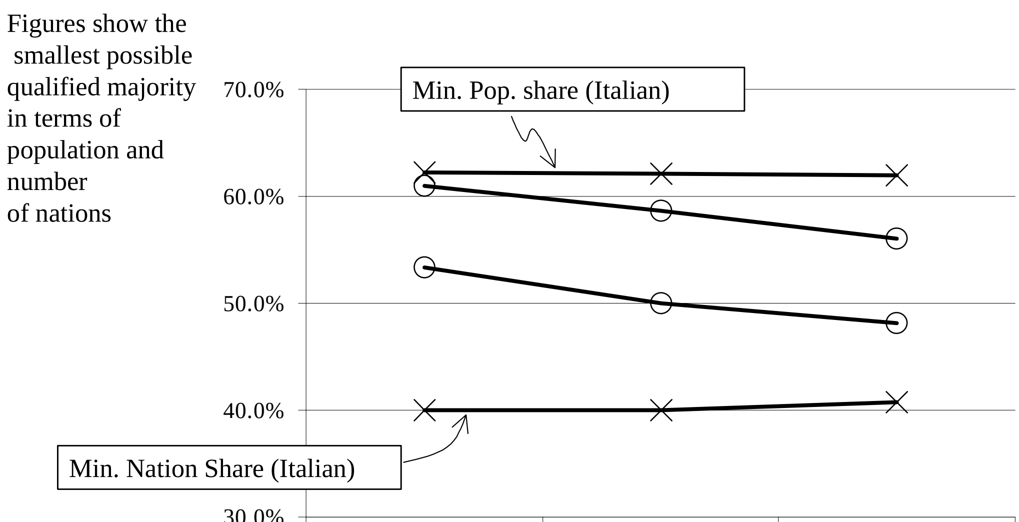
Legitimacy by the Numbers

All this said, democratic legitimacy is an elusive concept that defies all but the bravest attempts to quantify it. Indeed it is probably best left to politicians, but like it or not, number-crunchers are already involved. One set of numbers in particular has played an influential role – namely the minimum population share in a qualified majority – so it is worth considering these and other measures of legitimacy.

Figure 5 displays the smallest population share in a qualified majority for past and future EUs (assuming no reform). This share 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 documentation, is the fact that this figure will head toward 50% in an EU27. Even the first-wave enlargement would bring 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 is widely accepted as posing a threat to the legitimacy of the system.

Figure 6: Minimum Qualified Majorities with Reweighting



	EU15	EU20	EU27
Pop. Min., Swedish	60.9%	58.6%	56.1%
Nations Min., Swedish	53.3%	50.0%	48.1%
Pop. Min, Italian	62.2%	62.1%	61.9%
Nations Min, Italian	40.0%	40.0%	40.7%
Pop. Min., Swedish, 60%	46.5%	45.2%	41.4%
Nations Min., Swedish, 60%	40.0%	35.0%	37.0%

Source: Authors' calculations (evaluation.xls)

These figures, however, should be handled with care. Population shares only measure Union-of-People legitimacy. Union-of-States legitimacy suggests a different calculation – the smallest qualified majority in terms of the share of EU Member States. Surely a system would be viewed as illegitimate if a small number of members could impose their will on the majority of members – *a fortiori* if this minority consisted of big powerful states running roughshod over small ones. The dashed line in Figure 5 shows how this alternate measure of legitimacy has varied historically and how it will vary without reform. Without reform, the share would fall from its current level of 7/15 (58.3%) to just 14/27 (51.9%). Again, this begins to stretch the common notion of majority.

Next, we apply these legitimacy measures to the reform proposals.

Democratic Legitimacy of the Proposals

Figure 6 shows the smallest winning coalitions for the current and enlarged EUs under the two pure reweighting proposals, namely the Swedish square root formula and the Italian proposition. Consider first the Swede's design. This reform's main attraction lies in its ability to maintain the minimum population-share in a qualified majority near its current level. Even in the EU27, for instance, the minimum population share is close to 60% (56.1%). The plan's ability to do this depends entirely on the fact that it reduces the relative voting power of small nations.

Cutting the power of small countries, however, makes the system perform worse than it would with no reform on Union-of-States legitimacy. For example, if the Swede's rule were applied to the EU15, 53% of the Member States would have enough votes to get a proposal through the Council. In the EU27, the figure drops below the magical half-half line, with just 13 out of 27 nations necessary to win. The problem just gets worse if one lowers the majority threshold, as the table beneath the chart illustrates.

The figure also plots the smallest winning coalitions for the Italian proposal. The top line shows that this proposal does an excellent job of keeping the population share in a winning coalition near its current level of 60%. However, the bottom line shows that it does this at the cost of substantially worsening legitimacy as measured by the smallest number of nations in a qualified majority. Specifically, the number is about 40% for the EU15, EU20 and EU27. It seems clear that allowing considerably less than half the nations to get their way despite the opposition of 60% of the Member States would weaken the moral authority of this decision-making mechanism.

The minimum population and member thresholds for double majority reforms are set directly and so do not need to be illustrated with calculations.

Conclusion #2: Scylla and Charybdis

These results back up the point made above. Any big-versus-small reweighting plan places IGC negotiators in the horns of a legitimacy dilemma. A scheme that reweights towards big nations automatically lowers the fraction of members necessary to win in the EU27; a scheme that does not, allows the minimum population share to fall as 10 new small nations join. The dual majority plans resolve the dilemma by, in essence, allowing the EU to move its threshold in two directions at once. Of the dual majority plans, the simple dual majority is the purest in terms of the 2 Unions perspective. Put simply, dual majorities with weighted-Council-votes muddy the issue. Council vote-weighting is, after all, itself an attempt to combine Union-of-States legitimacy with Union-of-People legitimacy. A final, non-quantitative but non-negligible point is that the dual majority schemes 'sound' fair even without elaborate explanation.

Fairness Regressions: Comparison to the USA

As it turns out, there is a more formal – although somewhat abstract – measure of legitimacy in the sense of 'fairness.' Strange as it may seem, one very specific definition of fairness requires that power in the Council of Ministers be allocated to nations according to the square root of their population. Box 2 explains this peculiarity which appears to have inspired the Swedish reweighting proposal. As Laruelle and Widgren (1998) show, this square root rule also provides a touchstone for fairness and this permits a formal gauging of the proposals' fairness. To this end, we calculate the distribution of power under different reforms using a formal power measure (see Box 3). Second, we try to find the best fit between the power measure and the square root rule. If the fit is very good, the estimated coefficient should be unity.

Box 2. Fair and Square: Gestalt of the Square Root Rule

If everything in the Council of Ministers were decided by an EU-wide referendum, proportional representation would be fair. But even ignoring the Commission, 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 her national election, a typical German citizen has less power than a typical Luxembourger since each group of voters choose one government but German voters are 160 times more numerous. To ensure that each EU citizen is equally powerful in Council decisions, the German Council representative should have more power than the Luxembourg representative. But how much more? Using the formal power measures discussed above, we can arrive at 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 maths. Consider a randomly selected yes-no issue and suppose that Member States 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 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*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 decreases in a straight-line relationship with population. This misses a subtlety. 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 falls at a less than linearly pace. The mathematics of combinatorics gives us an exact formula assuming a voter's stance is randomly determined on a randomly selected issue. The equation is complex, but can be approximate with "Stirling's formula" as the square root of $2/n\pi$, where n is the number of voters. Hence the square root.

Table 1: How Well Does the Square Root Power Distribution Fit for EU27?

Reform Plan	Coefficient
No reform	0.92
Double simple majority	0.91
Double 60 % majority	0.81
Double 71 % majority	0.77
Swedish prop. 50 %	1.00
Swedish proposal 60 %	0.99
Swedish proposal 71 %	0.97
Limited reweighting (single majority)	
with 50% threshold	0.99
with 50% threshold	0.98
with 50% threshold	0.95

Note: Fairness by the square root metric requires the coefficient to be 1.
Source: Authors' calculations.

For comparison and as an illustration, consider the result of applying this metric to the U.S. Congress. Congress uses a double majority rule with states equally represented in the Senate and the seats in the House of Representatives allocated (more or less) in proportion to population. Passing a proposal requires a simple majority in both chambers. If we calculate the normalised Banzhaf Index (NBI, see Box 3) for the U.S. Congress and then fit the fairness criteria to it, we find that the estimated slope is 1.01, quite close to unity.

Table 1 shows how well different double majority schemes perform on this metric and the no-reform scenario is shown for comparison. All the schemes except perhaps the double 71% and double 60% plans give coefficients that are close to one. The Swedish weighting scheme with a 50% or 60% threshold is the one that comes closest. It is worth stressing that there is no clear-cut "right" value for the coefficient since the EU is two unions in one (of people and of states), but the numbers permit comparison across plans. ‘Which one is more desirable?’ is a question to be solved in Nice.

Having dealt with efficiency and legitimacy from the Member States’ perspective, we turn briefly to reform and the power of the Commission.

3.3. Political Acceptability of Proposed Reforms

Of the three dimensions – efficiency, legitimacy and acceptability – the last is where economists have the least to say. In the end, each national parliament must weight the impact of reform on their power against the benefits of expanding the Union. We can, however, illuminate this trade off using a formal ‘power-measuring tool.’ We will define and defend this below, but before doing so we argue that having such tools is enormously useful.

Enlargement, with or without reform, will redistribute power among the incumbent 15 and between incumbents and newcomers; our tool helps indicate the nature and direction of the shifts. The tools also provide a way of quantifying the ‘Protocol 11’ compensation whereby the Big-5 may give up their second Commissioner in exchange for more voting weight in the Council. In particular, we can determine whether the two main reweighting schemes would fully compensate big nations for their loss of a Commissioner.

In what follows, we explain our power measure and argue that it captures power in the EU in a meaningful way. Readers in a hurry can turn to page 18 to see its application to the question of reweighting compensation for lost Commissioners, and to page 20 for its application to measuring the impact of enlargement and reform on incumbent’s power.

Power Tools Required

The distribution of political power is the key to political acceptability since nations are reluctant to relinquish power. Clearly, a yardstick of power is needed, and implicitly or explicitly, negotiators in Nice will apply one to each proposal on the table. This is hard and as with the passage probability we use the Law of Large Numbers to make headway. However, unlike that passage probably we have some empirical support for power measures (Baldwin, Francois and Portes (1997)).

Box 3: Our Power Measure, the Normalised Banzhaf Index (NBI)

Our preferred measure – the normalised Banzhaf index (NBI) – gauges how likely it is that a nation could ‘break’ a winning coalition on a randomly selected issue. To calculate this likelihood, we ask a computer to identify the winning coalitions among all possible coalitions (in the EU15, there are 32,768 of these), and to work 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 swing voter as a fraction of the number of times that any country could be. The theory 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. Web Appendix 2 illustrates the concept more fully with the help of a simple example.

Power is impossible to measure directly but its impact on the world is unmistakable, budget allocations being one manifestation of power that is both observable and quantifiable. 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.

But why would the NBI be related to this measurable manifestation of power? 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 – 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 BI should line up with its budget share.

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.

Of course, anyone who reads the serious European press will tell you that power in the Council has nothing to do with EU spending; budget priorities are based on high-minded principles. Under this ‘Father Christmas’ view, the EU dishes 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 Web Appendix 3 shows that this belief is almost entirely wrong; the historical EU budget was driven entirely by power politics.

We take this as evidence that the NBI captures power in a meaningful way. Readers who accept this should read on to see it applied to the reform proposals. The sceptical should turn to Web Appendix 3.

Price of a Commissioner

The Amsterdam Treaty commits the Union to a reform of the Commission that is linked to reweighting. 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. The two main reweighting schemes considered above both shift voting weight towards large nations and so potentially satisfy the Protocol 11 test. To see if the proposed reweighting does indeed compensate the Big-5, we develop an extension of our main measuring tool, the NBI, which allows us to calculate national power when Commissioners matter. Understanding the extension requires a bit of background.

According to the Treaty of Rome and the oath all Commissioners take, European Commissioners are independent experts guarding the Treaties and promoting European integration. Not everyone believes this and the above mentioned protocol directly admits that Commissioners play a role in the distribution of national power. Pushing this view to an extreme, by viewing Commissioners as national representatives, allows us to roughly calculate the impact of Commissioners on national power.

Given the Commission's power of initiative, any proposal that passes the Council has, in fact, attracted a winning coalition in both Commission and Council. The Commission's decision-making rules are simpler than those of the Council. When the Commission decides on an issue that is contentious enough to require a vote, a simple majority rule is applied with each Commissioner having one vote. The Big-5 have two Commissioners each while other Member States have only one, so taking the cynic's view of Commissioners, the Big-5 have twice the voting weight of small nations. This means that the Commission systematically favours small nations in that it is more intergovernmental than the Council; Germany has five times the votes of Luxembourg in the Council but only twice its votes in the Commission.

Given these two voting schemes we can view the Commission-Council decision-making as a three-step procedure. Although this may sound artificial, it does reflect the decision-making procedure and formulating it thus helps us treat the process as if it were a single voting scheme. First, the Commission decides 'yes' or 'no' based on a simple majority with 1-vote-per-Commissioner. Second, the Council decides 'yes' or 'no' based on qualified majority voting. Third, the proposal passes only if both Commission and Council voted yes. In reality, the Council never votes if the Commission votes 'no', but this is unimportant; the three-step procedure and the actual one always produce the same outcome. We calculate the normalised Banzhaf Index for each nation in this three-step voting game and display the results (compared to status quo) in Figure 7.

Figure 7: The Commissioner-Council Vote Trade-off

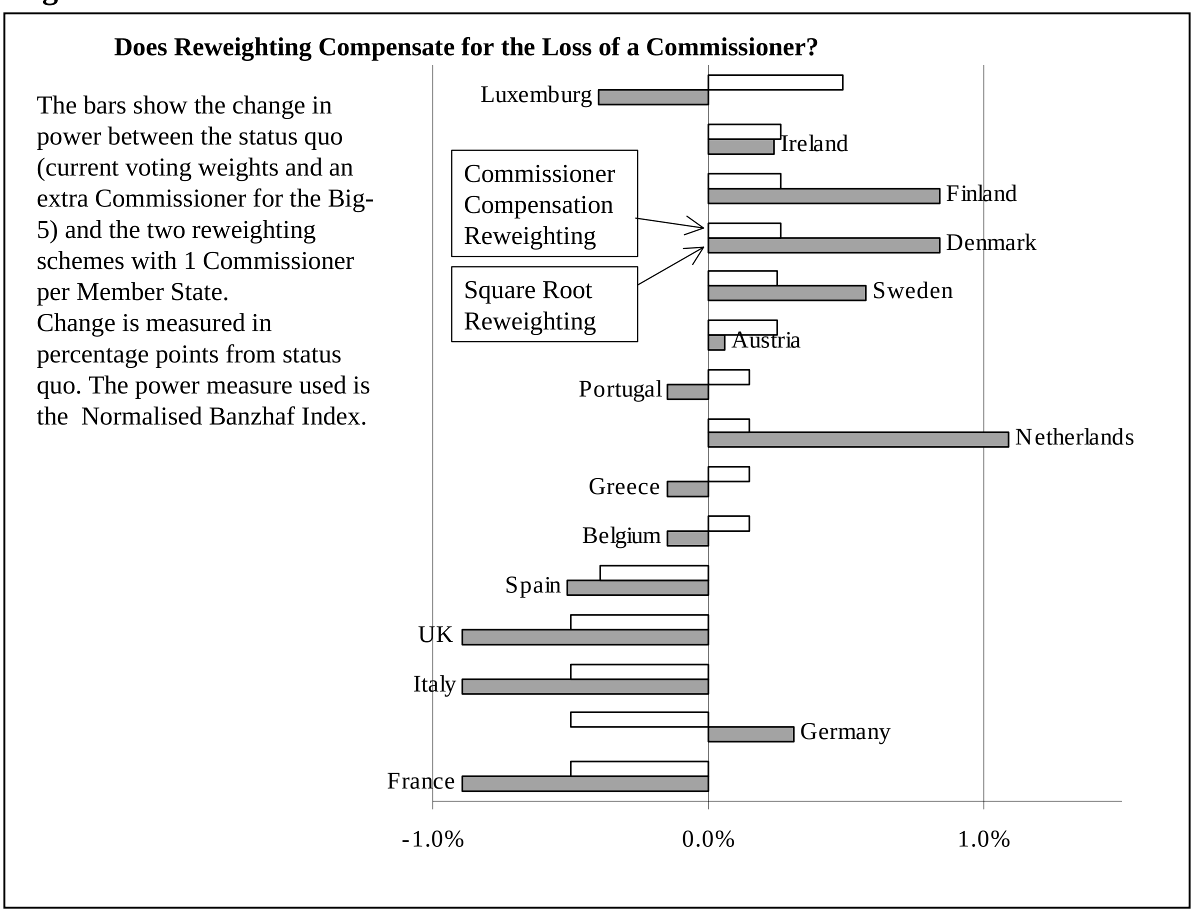


Figure 7 shows the extent to which two reweighting plans counterbalances the Big-5's loss of a Commissioner; the first is the Swedish rule and the second is the 'limited' reweighting plan (2 times current votes plus 5 per Commissioner lost) with a single 71% majority in the Council. The bars at the bottom of the diagram represent the numbers for the large nations. The fact that they are mostly in negative territory shows that the loss of a Commissioner is not fully balanced by the suggested increase in Council votes. The results for the commissioner-compensation plan (light coloured bars) show that all five of the Commissioner-losers find their power lowered by the exchange. Under this plan, however, the drop is not large. For the Big-4, for example, the drop is one-half of a percentage point reduction in their share of total Council power (as measured by the normalised Banzhaf index). For comparison, their status quo power shares are all about 11%. Unfortunately, we were unable to evaluate the Italian re-weighting plan since it was made public only a week before our deadline.

The diagram also shows that the square-root plan (shaded bars) leads to much larger redistribution of power. In particular, Germany gains slightly from the exchange, while the other Big-5 members lose almost a full percentage point on their power shares. This plan also leads to large gains for the Netherlands (more than a full percentage point gain on a base of just 5.5 %). Under current rules, the Netherlands, with its 15 million, gets the same number of votes as the 10-million members (Belgium, Portugal and Greece). With the square root rule, Holland gets a more reflective number of votes (8 versus 6 for the 10-millioners). Notice also that the square root rule provides hefty power boosts to Denmark, Finland and Sweden. Sweden gains 0.6% on a base of 4.8%, and the other two gain 0.8% on a base of 4.1%. The other big change is for Luxembourg who loses 0.4% on a base of 3.2%.

Overall, it is clear that the square root rule, whatever other merits it may have, will have an important redistributive impact on power in the EU.

Power Losses from Enlargement without Reform

Finally, we turn to the power impact of enlargement under the various reform proposals. For simplicity's sake, we focus on the impact of letting in 12 new members and to set the scene, we first look at how enlargement without reform would shift the power distribution.

Table 2: Power Redistribution with No Reform, EU12 to EU15 & EU15 to EU27

Change in Power (percentage points change in NBI)

	Current Power Shares	Change in Power Shares (measured in percentage EU12 to EU15	EU15 to EU27	Change in Power Shares (measured as %of base) EU12 to EU15	EU15 to EU27
Germany	11.2%	-1.7%	-4.2%	-15.0%	-37.7%
UK	11.2%	-1.7%	-4.2%	-15.0%	-37.7%
France	11.2%	-1.7%	-4.2%	-15.0%	-37.7%
Italy	11.2%	-1.7%	-4.2%	-15.0%	-37.7%
Spain	9.2%	-1.7%	-3.4%	-17.9%	-36.6%
Netherlands	5.9%	-0.9%	-2.0%	-14.8%	-34.6%
Greece	5.9%	-0.9%	-2.0%	-14.8%	-34.6%
Belgium	5.9%	-0.9%	-2.0%	-14.8%	-34.6%
Portugal	5.9%	-0.9%	-2.0%	-14.8%	-34.6%
Denmark	3.6%	-0.9%	-1.2%	-26.0%	-34.5%
Ireland	3.6%	-0.9%	-1.2%	-26.0%	-34.5%
Luxemburg	2.3%	0.5%	-0.7%	22.4%	-30.5%
Sweden	4.8%		-1.7%		
Austria	4.8%		-1.7%		
Finland	3.6%		-1.2%		

Source: Author's Calculations (evaluation.xls)

Table 2 shows the no-reform scenario and provides the impact of the last enlargement for comparison. Note that the entry in 1995 of three small nations reduced the power of all incumbents, more or less in proportion to their initial power shares. Denmark and Ireland did lose a bit more. The intuition for this is that the newcomers, with their 3 and 4 votes apiece, are fairly close substitutes (in terms of making or breaking coalitions) for 3 votes apiece held by the Irish and Danish. Luxembourg is, as usual, quite exceptional. It turns out her 2 votes come in handy in making or breaking a wide range of winning coalitions and this increases rather than decreases with the 1995 enlargement. Likewise, without reform the last column shows that all incumbents will lose a substantial amount of power, but again this loss is approximately proportional (roughly a third) to base-case power shares, although big members do lose somewhat more.

Reforms and the Power of Incumbents

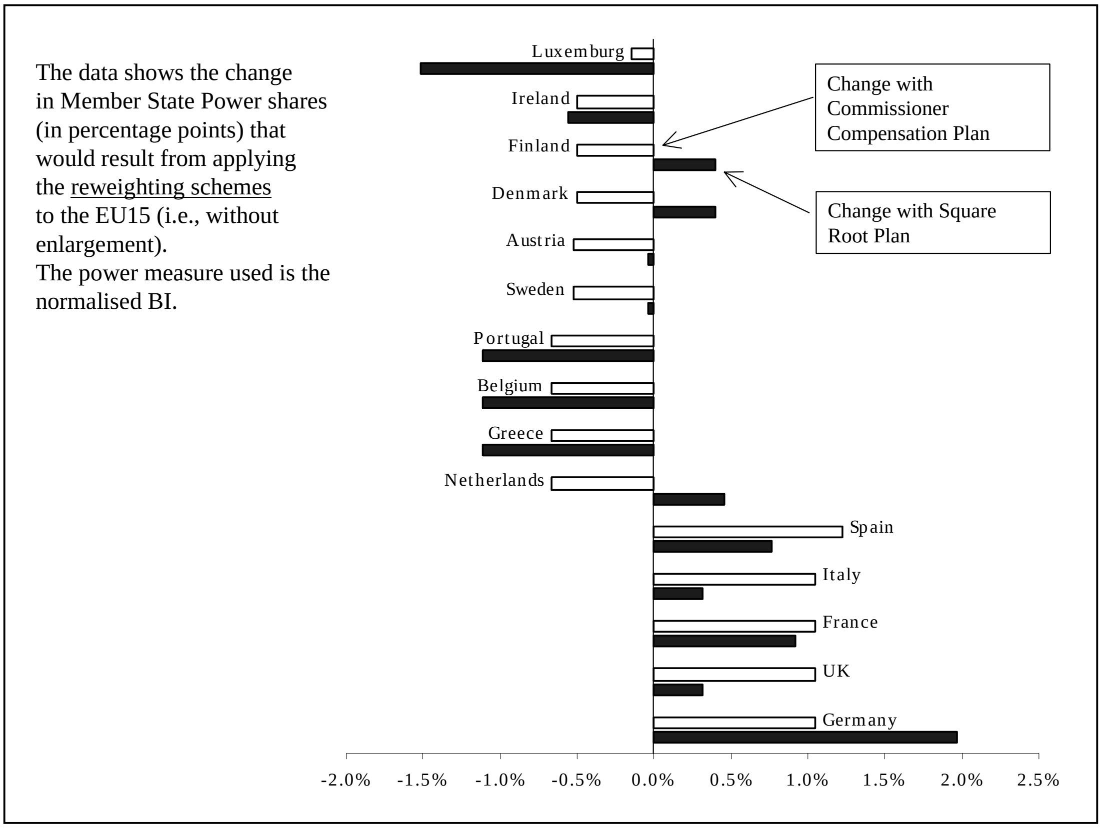
Independent of enlargement, the reweighting and double majority reforms will redistribute power. To illustrate this, we show how the various proposals would affect national power if they were applied to the EU15.[3] Figure 8 and Figure 9 display the results.

Observe that Figure 8 clearly shows that both the reweighting schemes shift power from small members to the large one. This is expected since this is their stated intention, but note the differences between the two strategies. First, the Swedish square root rule has a much bigger redistributive impact (as noted above), with the biggest gaining more and the smallest losing more. Moreover, the Swedish rule leaves the power of middle countries unchanged.

[3] It seems likely that whatever reform is adopted at Nice, or later, will not take effect until enlargement occurs, but this exercise provides a concrete measure of the power shifts implied by each proposal.

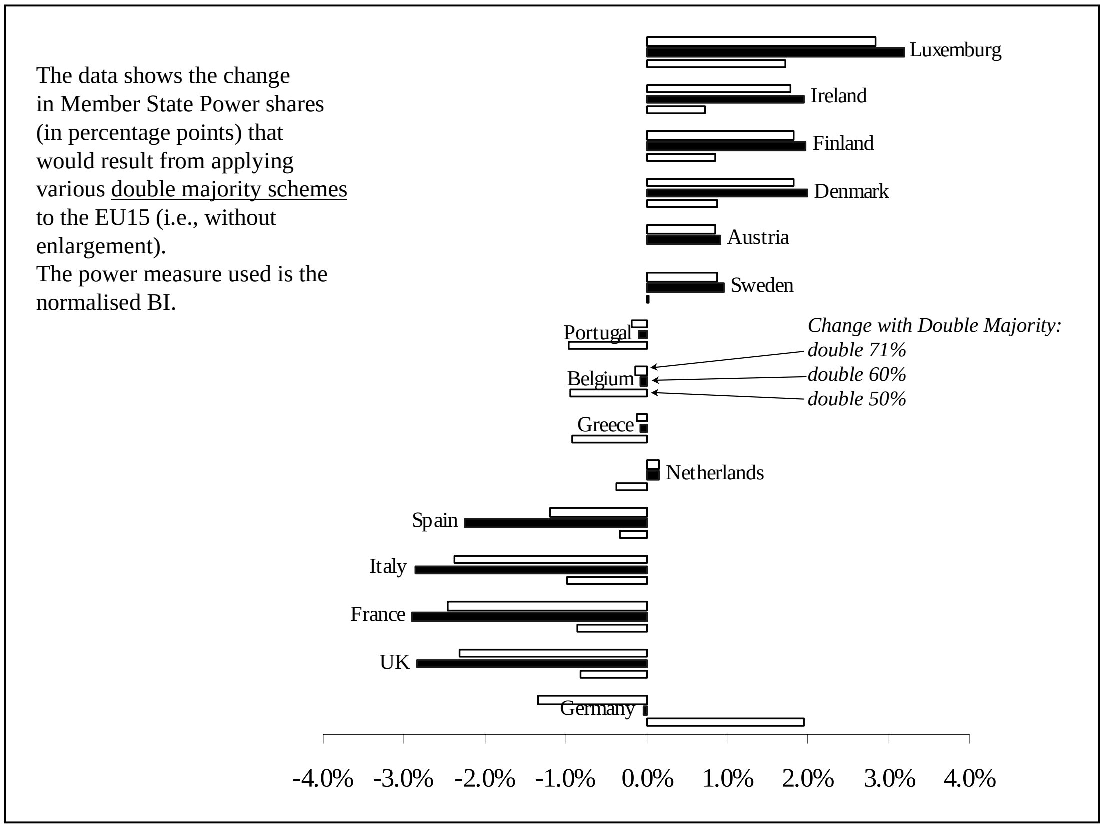
This is normal since, logically speaking, each reweighting scheme must have ‘fulcrum’, i.e. a middle-sized member whose power is unchanged by the weight shifting. For the commissioner-compensation scheme, the fulcrum nation would have a population somewhere between that of the Netherlands and Spain. For the Swedish square root rule, the fulcrum is – surprise, surprise – Sweden.

Figure 8: Power Redistribution with Reweighting Schemes.



The impact of double majority schemes on the power distribution is not obvious before doing the numbers. After all, the double majority plans shift voting weights in two conflicting directions. By giving nations one-vote each when it comes to the Member State threshold, the plan tends to increase the weight of small nations compared to their current Council voting weight (i.e. both Germany and Luxembourg get one vote, instead of 10 and 2 respectively). By contrast, when it comes to the population threshold, the plan radically shifts voting weight to big nations, again compared to current weighting rules.

Figure 9: Power Redistribution with Double Majority Schemes.



For instance Germany with her 82.0 million citizens would get, in essence, 82.0 votes toward the population threshold, while Denmark would get 5.3. This is much more progressive than the current 10 versus 3 voting weights in the current Council. While it is not generally possible to say which of these conflicting reweightings will dominate, our power indices let us quantify how the mix affects national power.

The results, displayed in Figure 9, show that the double majority schemes typically lower the power of big nations and raise that power of the small. The big exception is Germany under the double simple majority and the double 60% majority. Here Germany's massive population allows it to gain or maintain its power share.

This is leads us to another of our main findings.

Reweighting is Pro-Big, Double Majority is Pro-Small

The power impact of the double majority plans turn out to be almost exactly opposite to those of the reweighting schemes. Reweighting boosts large members' power at the expense of small members. Double majority does the opposite. The exact numbers are listed in Table 3

Table 3: Power Effects if Reforms were Imposed on the EU15.

Percentage Points Change with reform applied to EU 15 (normalised Banzhaf index).
These figures are calculated assuming that the Commission composition has no effect on national power because either the composition is unchanged, or because Commissioners are independent and do not contribute to national power.

	square root	Comm'r Comp.	Double 50%	Double 60%	Double 1%
Germany	2.0%	1.1%	2.0%	0.0%	-1.4%
UK	0.3%	1.1%	-0.8%	-2.8%	-2.3%
France	0.9%	1.1%	-0.9%	-2.9%	-2.5%
Italy	0.3%	1.1%	-1.0%	-2.9%	-2.4%
Spain	0.8%	1.2%	-0.3%	-2.2%	-1.2%
Netherlands	0.5%	-0.7%	-0.4%	0.2%	0.1%
Greece	-1.1%	-0.7%	-0.9%	-0.1%	-0.1%
Belgium	-1.1%	-0.7%	-0.9%	-0.1%	-0.1%
Portugal	-1.1%	-0.7%	-1.0%	-0.1%	-0.2%
Sweden	0.0%	-0.5%	0.0%	1.0%	0.9%
Austria	0.0%	-0.5%	0.0%	0.9%	0.9%
Denmark	0.4%	-0.5%	0.9%	2.0%	1.8%
Finland	0.4%	-0.5%	0.9%	2.0%	1.8%
Ireland	-0.6%	-0.5%	0.7%	2.0%	1.8%
Luxemburg	-1.5%	-0.2%	1.7%	3.2%	2.8%

The Combined Power Impact: Enlargement and Reform

The last set of power-changes-of-interest concern the impact of enlargement on incumbents' power under the various reform proposals. The calculations are presented in Table 4. Note that in all cases, the starting point for the change calculation is the EU15 power share under current voting rules, so a negative number indicates how much incumbents would lose from enlargement plus reform.

Table 4: Power Effects of Enlargement with Reforms

Power Changes, EU27 versus EU15 under Various Reforms
(status quo power in the EU15 is the initial point for all reforms)

	square root	Comm'r Comp.	Double 50%	Double 60%	Double 1%
Germany	-2.6%	-3.4%	-1.7%	-4.2%	-5.4%
UK	-3.6%	-3.4%	-4.1%	-5.6%	-6.3%
France	-3.6%	-3.4%	-4.2%	-5.6%	-6.3%
Italy	-3.6%	-3.4%	-4.3%	-5.6%	-6.3%
Spain	-2.5%	-2.4%	-3.9%	-4.6%	-5.0%
Netherlands	-1.5%	-2.4%	-2.4%	-2.3%	-2.3%
Greece	-2.5%	-2.4%	-2.8%	-2.5%	-2.4%
Belgium	-2.5%	-2.4%	-2.8%	-2.5%	-2.4%
Portugal	-2.5%	-2.4%	-2.8%	-2.6%	-2.4%
Sweden	-1.5%	-2.0%	-1.8%	-1.5%	-1.4%
Austria	-1.5%	-2.0%	-1.9%	-1.6%	-1.4%
Denmark	-0.8%	-1.5%	-0.9%	-0.5%	-0.2%
Finland	-0.8%	-1.5%	-0.9%	-0.5%	-0.3%
Ireland	-1.4%	-1.5%	-1.0%	-0.5%	-0.3%
Luxemburg	-1.7%	-0.8%	0.1%	0.7%	1.0%

Generally, our results suggest that the big nations would lose more power from enlargement if the 60% and 71% double majority schemes were implemented than they would under the reweighting schemes and the opposite is true for small nations. For the double simple majority scheme, the change in power approximates that of the reweighting schemes. The reason for this is not difficult to find. Under the double majority with a high threshold, the enormous overweighting of small nations with respect to the Member State threshold (1 vote regardless of population) gives the numerous little nations ample opportunity to make or break coalitions. With the higher 50% threshold, these small nations are individually close substitutes for each other, but the big nations (with about 12% of the population each) matter a lot in the sense that they are frequently crucial to a winning coalition.

Table 5: Council Vote Re-Weighting Proposals

	Pop. 99	Current	Swedish	Italian	"limited" or "Comm'r Comp"
Germany	82.038	10	18	33	25
United Kingdom	59.247	10	15	33	25
France	58.966	10	15	33	25
Italy	57.612	10	15	33	25
Spain	39.394	8	13	26	21
Poland	38.667	8	12	26	21
Romania	22.489	6	9	14	12
Netherlands	15.760	5	8	10	10
Greece	10.533	5	6	10	10
Czech Republic	10.290	5	6	10	10
Belgium	10.213	5	6	10	10
Hungary	10.092	5	6	10	10
Portugal	9.980	5	6	10	10
Sweden	8.854	4	6	8	8
Bulgaria	8.230	4	6	8	8
Austria	8.082	4	6	8	8
Slovakia	5.393	3	5	6	6
Denmark	5.313	3	5	6	6
Finland	5.160	3	5	6	6
Ireland	3.744	3	4	6	6
Lithuania	3.701	3	4	6	6
Latvia	2.439	3	3	3	6
Slovenia	1.978	3	3	3	6
Estonia	1.446	3	2	3	6
Cyprus	0.752	2	2	3	4
Luxembourg	0.429	2	1	3	4
Malta	0.379	2	1	3	4
EU15	375.325	87	130	235	199
EU20	437.798	111	160	287	252
EU27	481.181	134	190	330	298
Turkey	64.385	10	16	33	25
EU28	545.566	144	206	363	323

Pop. & vote data from CONFER 4750/00 and CONFER 4796/00

PART 2

The ECB Must be Restructured Before Enlargement and the Euro Group Should be Formalised

4. Why Nice Should not Shy Away from this Discussion

Enlarging an unreformed ECB to include 5 or 12 new members would be very dangerous. The resulting Governing Council would be a big, unwieldy group. Even in the most optimistic view, ECB decision-making would get much harder. Decision-making difficulties typically favour the status quo, so this ECB would have trouble performing the main task of a Central Bank -- taking difficult decisions at the right time. Moreover, the Governing Council would probably be marked by fractious debates, a further loss of democratic legitimacy and – potentially – a loss of credibility.

The outcome, however, need not be this rosy. In one scary though improbable scenario, the ECB could become divided into a dozen or more 'Irelands' and a handful of 'core' nations, with the 'Irelands' having enough votes to set interest rates while accounting for only 20% of Euroland output.

The urgency and importance of these problems cannot be exaggerated. As far as importance goes, it suffices to note that the EMU will soon be the major macroeconomic policy maker for more than 400 million Europeans. fMaintaining a functional ECB decision-making apparatus should thus be a top EU priority. As far as urgency is concerned, it should be enough to note that reform will just get harder post-enlargement. It should also be mentioned that financial markets are forward-looking and thus need no more than the possibility of a dysfunctional ECB to react negatively.

The Emperor's New Clothes

Wishful thinking and politically motivated myopia has led the EU to ignore this self-evident problem. How else can one explain the 'disconnect' between the universal recognition that the Commission must be reformed and the equally universal silence on ECB reform?

This section explains why an enlargement that pays no attention to the ECB structure is dangerous. In the course of this, we argue that if the EU enlarges in early 2004 the newcomers' power in the Council of Ministers could bring about EMU enlargement as early as mid-2005 – at least for well-prepared newcomers such as Estonia. We also work through what decision-making would look like in an unreformed but enlarged ECB, and discuss a number of reform options.

As part of this, we argue that there is no benefit from denying that EMU is *de-facto* an area of re-enforced co-operation: doing so undermines the credibility of the EU as a democratic institution—Danish voters have clearly expressed their view on this point—and does not help running EMU effectively. But thinking about EMU as an area of re-enforced co-operation has an additional benefit: it provides an ideal case study for the testing the effectiveness of the provisions concerning re-enforced co-operation that are being added to the Treaty. If they do not work for EMU, they could turn out to be insufficient in other areas as well.[4]

5. The Problems of Expanding the ECB on Existing Lines

Given the strong desire of candidate countries to join EMU, it seems likely that the monetary union will expand soon after EU enlargement. Without reform, this could lead to serious problems, and we turn now to explaining why. To this end, we first flesh out why EMU expansion could come very rapidly after enlargement, and then show how an enlarged but unreformed ECB could malfunction.

5.1. All Aboard: EMU Expansion in 1 June 2005?

EU leaders seem to be avoiding the issue of EMU expansion by claiming that it is a long way off (see Box 4). This is unrealistic. The Treaties state that all EU members can join the ECB as soon as the Council of Ministers makes the political judgement that they meet the convergence criteria. This will come sooner than many expect, maybe as early as 1 June 2005 by our calculations.

Box 4: Duisenberg on EMU Enlargement and ECB Reform

At the 13 April 2000 ECB press conference in Frankfurt:

Question: "…what exactly has been discussed in this respect - the speed of, let's say, coming into the euro 'orbit'".

Duisenberg: "… in the process of accession, you have to clearly distinguish between, I would say, three phases. … accession to the EU … entry into the European ERM. And, third … entry into Monetary Union… all in all, we are talking about a process - I do not want to give the idea that we have a precise figure in mind - but we are talking about a process which, to my mind, will take at least a decade to be fully completed.

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 organisation of the European System of Central Banks, including the ECB**.

12 September 2000 before the Committee on Economic and Monetary Affairs of the European Parliament:

Duisenberg: "… There could be a problem with the Governing Council, currently consisting of 17 Members, if that number were to be greatly increased, but that is still a long way off. … in our view, **the time is not yet right after a year and a half in existence to start thinking about or discussing changes in the composition or nature of the decision-making bodies of the ECB, and we have ample time to do that at a later stage.** What we are talking about here is not accession to the EU but basically accession to monetary union, which will come years after actual accession to the EU."

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[4] The process of European integration has always advanced in steps: the single market evolved from the experience of running the common agricultural market; EMU itself was the natural evolution of the EMS. The Union was not designed at the drawing board: its institutions have often grown out of experiments in specific policy areas

EMU Membership Timeline

The Treaties lay down a very specific procedure for joining EMU, which is illustrated in Figure 10. Only after joining the EU can the newcomers join the ERM2, and this is necessary to start the 'reporting period' clock. The Treaty specifically requires that compliance with the debt, deficit, interest rates and inflation targets be evaluated over the year before the examination. However, the reporting period is 2 years for the exchange rate criteria (ERM membership without devaluation), so the evaluation cannot theoretically be passed until a 2-year track record exists.[5] Of course, practice and theory have deviated (as we shall see below), but 2 years is what the Treaty says.

Figure 10: Membership to EMU Timeline, according to the Treaty

<u>Timeline as in the Treaty</u>

<u>Earliest Probable Date</u>	**<u>Event</u>**
1 January 2004	EU Accession (voting rights in General Council)
	<u>Reporting Period: 2 Years</u> (1 year prior to examination for inflation, LT interest rate, budget & debt; 2 years prior to examination for ERM criteria)
1 January 2006	
	<u>Data and report writing lag*:</u> (2 months)
1 March 2006	Commission & ECB "Convergence Reports"
1 April 2006	Council of Ministers (Ecofin) votes by "qualified majority" on Commission proposal
	<u>Changeover Period:</u> (6 months)
1 October 2006	Voting rights in Governing Council

* Commission Report on 1st 11 members came 25 March 1998, based on data up to March 1998; Council voted on 2 May 1998; accession to EMU on 1 January 1999. Commission & ECB Reports on Greece came on 3 May 2000, based on data up to March 2000; Council accepted in June 2000; accession to EMU 1 January 20001.

After the 2nd accession anniversary, the Commission and ECB need about 2 months to get the final data and write their 'Convergence Reports.' These assess the suitability of all non-EMU Member States for EMU membership based on compliance with the EMU-related *acquis* and the Maastricht economic convergence criteria. The relevant *acquis* mainly involve central bank independence, capital mobility, and banking and financial stability, things that most newcomers will have under their belts before EU membership. The Maastricht criteria require inflation rates, government deficits and debts, and long-term interest rates to have been low enough, and exchange rates to have been stable enough in the report periods. While there are other criteria, experience shows that if these are met, the member will be judged to be fit to enter Euroland. The Ecofin Council will then deliberate on the reports for at least a month, suggesting that the Ecofin vote can come no sooner than 27 months after EU accession. If the

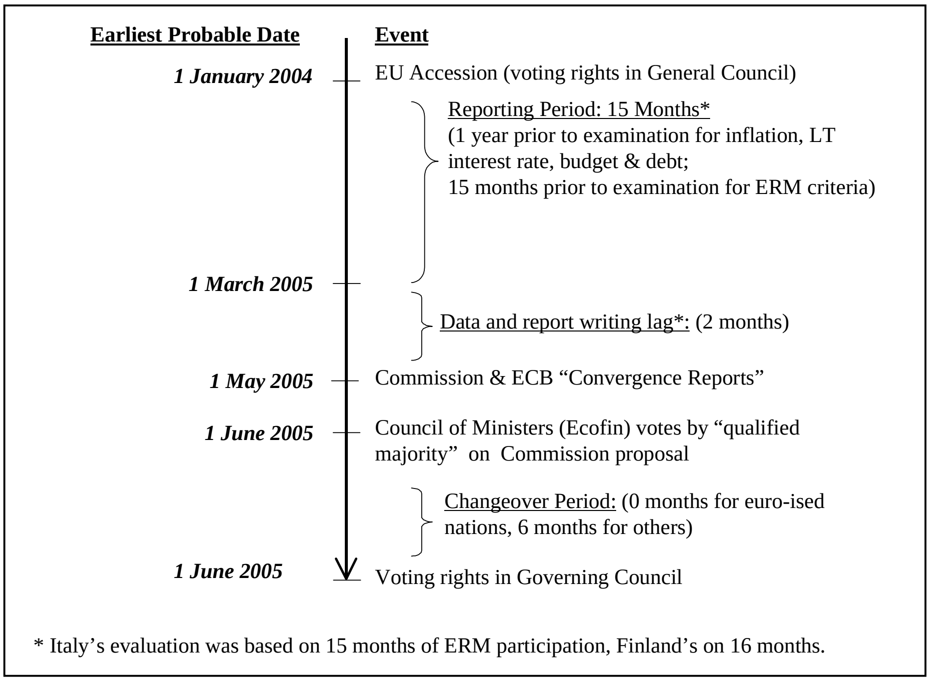
[5] Interestingly, revaluation is permissible and was tolerated for Ireland and Greece, although it indicates a difficulty in adjusting to external competitiveness without an exchange rate.

answer is ‘yes’ the EMU-members-elect may need some time to adopt the euro. The founding members took 8 months and Greece is taking 6, so voting rights in the Governing Council should come about 6 months after the Ecofin decision. If the rules are followed to the letter, the process should take at least 33 months.

‘To make judgement wholly by the rules is the humour of a scholar’, Sir Francis Bacon

The Treaty-writers explicitly granted the entry judgement to a political body knowing that political pressure would make for exceptions. Here we look at those affecting the minimum EU-to-EMU delay.

Figure 11: The Timeline with Euro-isation and the Italian ERM Period.



In 1998, great political pressure mounted to make Italy and Finland founding EMU members since these nations had made astounding efforts to meet the criteria. This required an exception as Italy had been in the ERM for only 15 months before the examination (16 months for Finland). The Commission and the EMI (the ECB’s precursor) more or less coalesced with the politicians in overlooking the 2 year ERM requirement.[6]

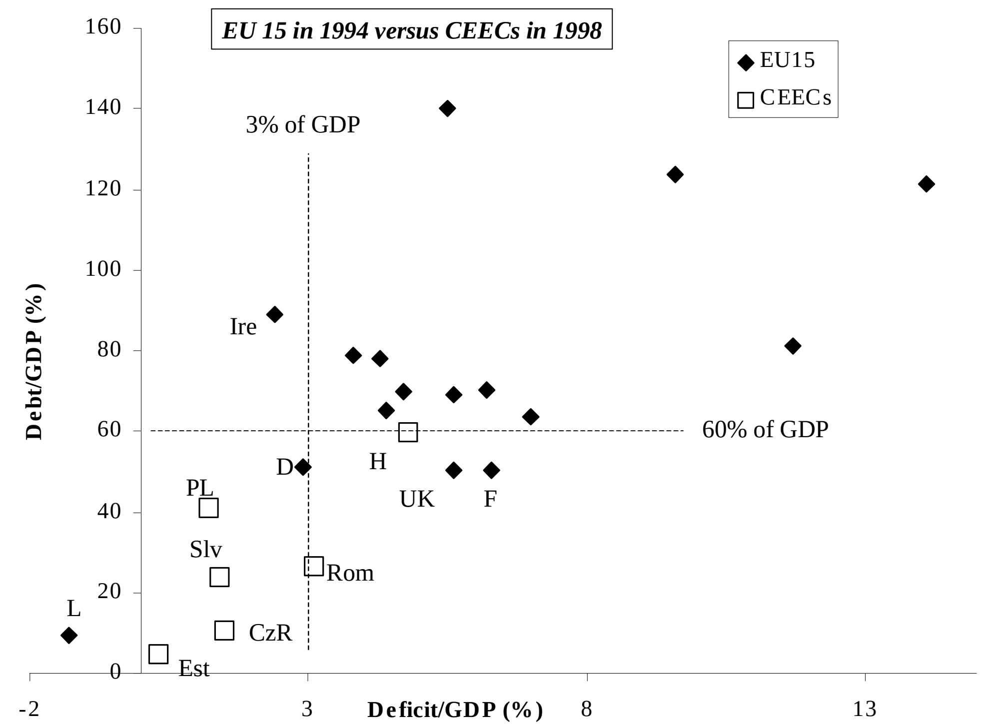
This exception was well reasoned and both countries satisfied the 2-year period before EMU’s launch, but it set a precedent. Given this, it will be exceedingly difficult to hold a nation like Estonia to a 2-year waiting period. Estonia has, after all, been tied to the euro (via its DM currency board) for longer than Greece. Once an exception is made for one new Member State, how likely is it that the others will be denied?

[66] ‘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 provide 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.

In short, this Italian-Finnish precedent slices 9 months off the *de jure* timeline. Euro-isation could take another 6 months off.

Greece passed the convergence test in June 2000, but cannot sit on the ECB until it has adopted the euro and this is projected to take 6 months. Not all of the applicant nations will face such a delay. With her currency-board peg to the DM, Estonia has effectively been using the euro since EMU started and Estonians have seriously contemplated adopting the euro as their national currency once banknotes have been issued in 2002. This would mean no delay, or a very short delay, between Ecofin's approval and voting rights in the ECB. Other applicants may follow this example.

Figure 12: Then and Now: EU15 in 1994 vs CEECs in 1998



Source: 1994 data, EMI Annual Report, 1994; CEEC data from Deutsche Bank Research (2000)

All of this implies a minimum timeline that is 15 months faster than the 33 months suggested in Figure 11. In short, the first new EMU members could join as early as 1 June 2005, presuming the first EU enlargement happens on 1 January 2004. Of course, maybe only Estonia would be ready then, but given the astonishing Greek effort, it could well be more.

As usual, observers differ: Gros (2000) estimates July 2006, and Deutsche Bank Research (2000) guesses 2007 as the earliest date, but this makes little difference. Whether it is 2005, 2006 or 2007, 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 some time, since they will not be able to fulfil the Maastricht convergence criteria. This is more wishful thinking. A glance at the data show that on the difficult debt and deficit criteria, the frontrunner candidate nations are now better prepared for membership than the current EMU members were at a comparable stage. Taking the first EMU enlargement date as 2006, there is still 6 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 12 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.

On the exchange rate criteria, the CEECs are again in better shape now than the incumbents were 5 years before they joined. With the exception of the traditional DM-bloc nations, exchange rates in Europe were a mess in the 1992-1994 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 in Table 6. Here we see that the CEECs are in far worse shape than the current EMUers were 5 years before the start of EMU. Their 1998 inflation numbers are bad compared to the low euro inflation rates. Worse yet, many of the CEECs do not even have long-term interest rates since they have no l0 year government bonds. Inflation and interest rates, however, are two macroeconomic variables that can be changed over a period of, say, 2 or 3 years by a sufficiently determined government. Exhibit A is Greece's turn around between its 1998 EMU rejection and its 2000 success.

Table 6: Inflation and Interest Convergence Criteria, Then and Now

	Inflation, 1994	LT interest rate, 1994		Inflation, 1998	LT interest rate, 1998
Belgium	2.4	8.3	Latvia	4.7	
Denmark	2	9.1	Lithuania	5.1	
Germany	3	7.8	Slovkia	6.7	
Spain	4.7	11.8	Slovenia	8	
France	1.6	8.3	Estonia	8.2	
Ireland	2.4	8.8	Czech Republic	10.7	7.0
Italy	3.9	12.3	Poland	11.8	10.2
Luxembourg	2.1	6.2	Hungary	14.3	9.2
Netherlands	2.7	7.8	Bulgaria	22.3	
Portugal	5.2	11.7	Romania	59.2	
UK	2.4	8.9	Estonia	8.2	
EU-12	3.1	9.6			
Austria	2.8	7.6			
Finland	3.7	10.1			
Sweden	2.2	10.7			
Greece (failed)	**5.2**	**9.8**			

Source: ECB Monthly Report, February 2000; EMI Annual Report, 1994.

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), many political exceptions have been made as **Error! Reference source not found.Error! Reference source not found.** shows. In the year they were judged ready for EMU, only 4 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 criteria, 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 things to the writers of the Treaty and another thing after the 1992-1994 exchange rate crises.

Given this history, an outside observer – particularly one with an interest like the CEECs – would be justified in thinking that the Maastricht criteria will be subject to political interpretation when the time comes. We turn next to considering what sort of political power the newcomers will have in 2006.

Power Politics and the Convergence Judgement

The evaluation duty now falls to the Council of Ministers composed of Finance ministers (Ecofin). The decision is taken by a qualified majority, but qualified majority votes are not the only source of power in the EU.

Table 7: Historical Compliance with the Maastricht Criteria

	Inflation	long term int.rates	excess deficit ratio	debt/GDP	ERM 2-years 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 (failed)	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
UK	1.8%	7.0%	1.9%	53.4%	no
98 ref. values	2.7%	7.8%	3.0%	60.0%	
Greece (00)	2.0%	6.4%	1.6%	10440.0%	yes
00 ref.values	0.024	0.072	0.03	0.6	

European Commission Converge Reports, 1998 and 2000.

The EU typically operates in a very gentlemanly manner. In part, this is due to the good nature of the participants, but more concretely, it is because each and every member has the ability to block progress single-handedly. The point is that many of the most important things the EU does, such as the budget, Treaty reforms and accession decisions, are decided unanimously. This gives every member a veto. Members do not use this power in a frivolous manner, but they have often used it to achieve ends that they felt were morally justified, even when this involved severe conflict with other members. The French 'empty seat' policy and Prime Minister Thatcher's trenchant demands for a rebate are but two examples.

Imagine the Estonian, Slovenians, Hungarians, Czechs, Slovaks, Latvians, Lithuanians and Poles all deeply wanted EMU membership 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. The EU will be working on a new long- term budget plan ('Financial Perspective') in 2005. According to the timeline in Figure 10, this is exactly when Ecofin will have to vote on EMU enlargement. Is it unreasonable to suggest that that the CEECs might implicitly trade their vetoes over the budget to win the EMU membership vote? 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, find it perfectly justifiable to threaten to veto reform unless they are assured early EMU entry.

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

The Unstable ERM2

The argument for early EMU entry could be strengthened by the sort of exchange rate crises that marked the first ERM. Indeed, asking the new members to join the ERM2 and at the same time give up capital controls would expose them to speculative attacks, which could strengthen the argument for letting them into EMU. 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.

5.2. Track Out Ahead: Decision-Making in a Big Unreformed ECB

EMU enlargement would pose few problems if one of three conditions held:

- all Central Bank Governors cared <u>only</u> about Euroland average inflation and unemployment;
- all the entering economies were identical to the current Euroland average;
- the new comers were given GDP-weighted votes.

Unfortunately, the national Central Bank Governors surely have national-perspective biases, the new entrants are very different economically, and the Baltic States are slated to have more ECB votes than Germany and France combined.

This, as argued above, would be unworkable. In what follows, we first argue that Central Bank Governors do care about their homelands when voting. Then we detail the ways in which the newcomers' economies differ as far as structural inflation and monetary conditions are concerned. Finally, we discuss what all this would mean in an unreformed ECB of 23, 30, 33 members.

Box 5: Decision-Making in the US Fed

The US FOMC 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 Fed alternate. All Board of Governor governors are political appointees. A local board appoints the regional bank presidents (with heavy-handed supervision from the Fed chairman). The Presidents are guided by their board, which is made predominantly of local bankers and business people.

Regional Concerns Do Motivate Central Bank Governors

We do not and cannot know how much the votes of Central Bank Governors are influenced by economic conditions at home. Yet this matters enormously, so it is worth entertaining more indirect evidence and arguments. The strongest logical argument for national biases is based on what economists' call 'revealed preferences.'

Box 6: Evidence on Regional Biases in US Federal Reserve Voting.

On the issue of regional motives in setting monetary policy, there is ample evidence from a long history of voting on the US Federal Reserve Open Market Committee (FOMC). Havrilesky and Gildea (1995) show in detail 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 to determine on which side of the split a particular member of the FOMC votes. Economists, uniquely, are "reliable" in that they vote a pattern rather than politics. But 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. (p.279)"

The next issue is whether, bank presidents respond to local conditions. The evidence on this issue 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 find the opposite.

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. but plain common sense tells us that – at least in part – Member States insisted that these Governors be on the voting body in order to look after national interests. A clearer picture will emerge when Member States start to debate changing the one-nation-one-vote rule.

There is also some indirect empirical evidence available. The US Fed has a similar structure with a technocratic board and regional representatives (see Box 5). This is an imperfect comparison, of course, but the homogeneity of Americans suggest that regional representatives on the Fed are <u>less</u> likely to have a regional perspective than would European regional representatives. As it turns out, even in homogeneous USA, there is some evidence that regional economic developments affect the votes of regional representatives. This casts some indirect doubt on the non-nationalism of the governors.

The 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 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 the similarity of <u>changes</u> 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 macro economic characteristics. In particular it means that they are likely to experience higher growth and higher inflation for decades.

Balassa-Samuelson Inflation as a Persistent Source of Conflict

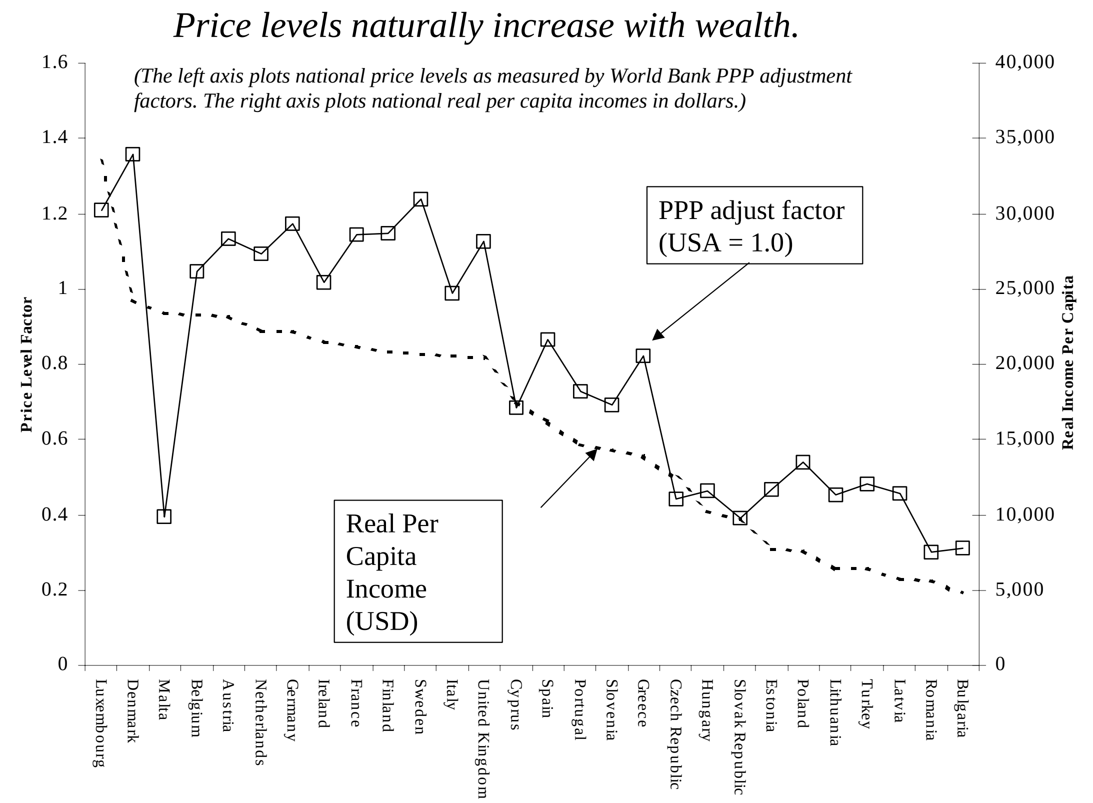
If all goes well, the CEECs will grow 2 or 3 times faster than West Europeans for decades. Indeed, this is what will be required for them to catch up to West European productivity and thus income levels. As it turns out, higher 'non-monetary' inflation is a corollary of this. Here is the argument.

Poorer nations typically have lower price levels than rich nations. Specifically, although 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. Note that this is purely structural inflation, not inflation driven by too much money chasing too few goods. Paul Samuelson and Bela Balassa first identified the effect, hence the Balassa-Samuelson moniker. This point is made graphically for the CEECs in Figure 13.

Importantly, this structural inflation difference might make the enlarged ECB adopt a tighter monetary policy. For instance, imagine how difficult it would have been for the ECB to cut rates in 1999 if there were 14 Irelands sitting around the table.

Whether it leads to tighter or looser money, the main point is that the newcomers' macroeconomies will be different for decades and this will create tension in the ECB. Even mechanically, differences in inflation rates between high- and low-growth countries should be taken into account by the ECB when setting monetary policy. Initially the weight of the new entrants in the euro basket would be very small, like that of Ireland today. But as they grow, so will their weight.

Figure 13: Structural 'Balassa-Samuelson' Inflation in Applicant Nations.



As CEECs' incomes catch up, they too will become high-priced European nations and this process means they will have an inflation differential. Germany's price level is 1.17 while Poland's is 0.54 (a level of 1.0 would indicate prices, measured in dollars, were in line with US prices). To close the gap, Poland needs a cumulative inflation differential of 63 percentage points. Even if this were spread over 20 years, the Polish inflation rate would be roughly 3% higher than German's for purely structural reasons. Gross (2000) suggest that the Balassa-Samuelson effect would lead to an annual structural inflation differential of 3.5 to 4% for the average CEEC.

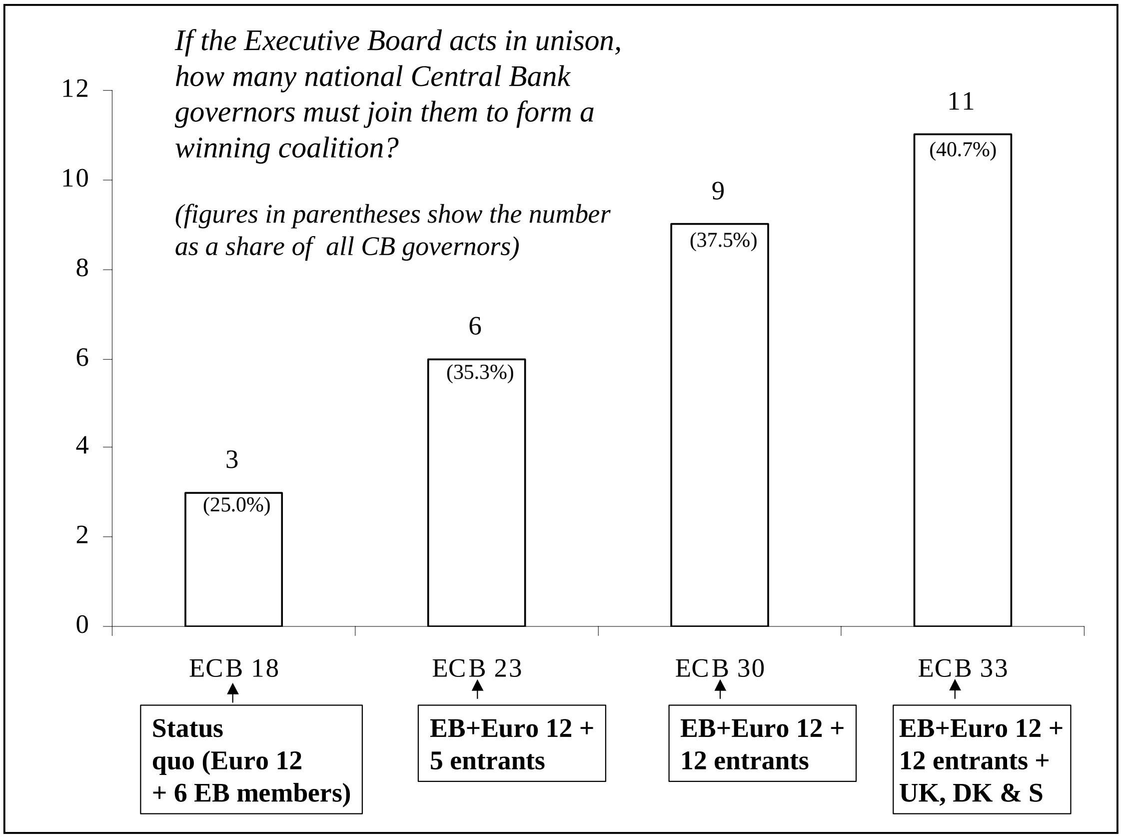
Voting in an Un-reformed Governing Council (GC)

The Governing Council of the ECB decides interest rate changes for Euroland. In practice, 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. Once Greece is in, the Council will have 18 voters – 6 Executive Board members and 12 Central Bank Governors – each with one vote. With this group, the simple majority rule means 9 votes are needed for the President's proposal to be adopted (the President decides in the case of a tie). Supposing that its 6 members act in unison, the Executive Board currently needs to find only 3 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 Euroland member gets a vote on the Governing Council. Figure 14 considers what decision–making would look like when 5 (say Estonia, Hungary, Czech Republic, Slovenia and Poland) of the applicants are in the monetary union, when all 12 of the applicants are in, finally when all 12 applicants plus Denmark, Sweden and the UK are in. These ECB enlargements imply ECBs of 18, 23, 30 and

33 voters respectively (eventually, the euro will probably also reign in Albania, Croatia, Serbia, Montenegro, Macedonia and Bosnia, 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.

Figure 14: Enlargement and the Rising Difficulty of Decision-Making



The main fact shown in Figure 14 is that enlargement gravely weakens the relative power of the Executive Board. The number of Central Bank Governors that must be lined up almost triples, from 3 to 11. Even as a share of the governors sitting as the table, enlargement raises the bar, from just 25% in the current ECB 18, to over 40% of them in the ECB 33. Plainly, this will make it much harder for the Executive Board to guide monetary policy.

A straightforward consequence is that national interests may become more dominant in an enlarged but unreformed ECB. This could be divisive and hinder the smooth conduct of monetary policy.

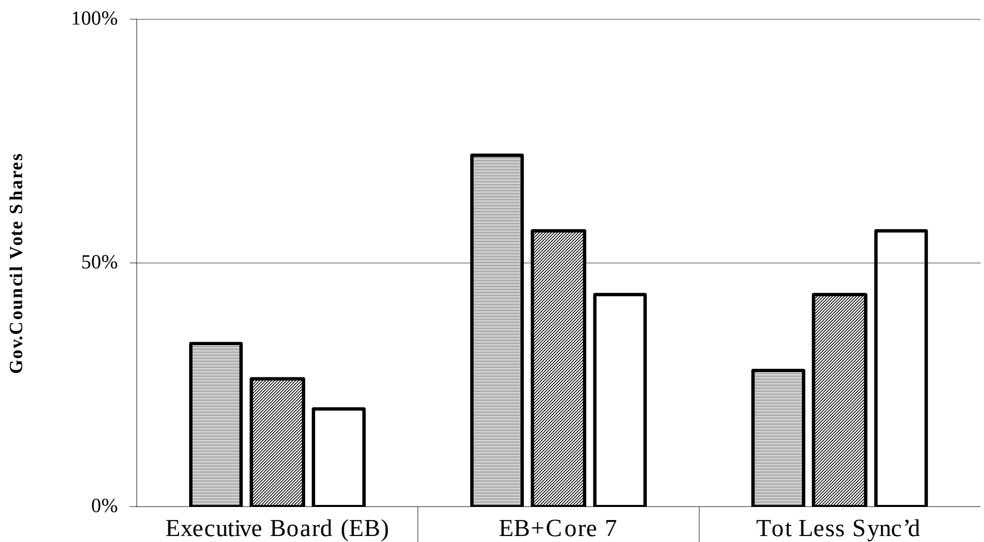
Hypothetical Alliances in an Enlarged Governing Council

Another way to make this point is to look at hypothetical coalitions that might form post-enlargement. To do this, however, we need to address the issue of the Board's and the governors' positions on monetary policy. According to its mandate, the Board's goal is to keep Euroland average inflation in a 0-to-2% band. There are some indications that it cares about extremes as well as the average (MECB, 2000). But suppose for the sake of argument that the Board's only concern is the Euroland average inflation. Roughly speaking, this means that it cares about the average national inflation rate, where the averaging uses weights that are related to the *economic size* of member nations (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 Euroland inflation average. What all this means is that the Executive Board, which probably cares about the Euroland average, will find natural allies among these 'core' economies – even if all governors take purely national perspectives. Under this analysis, Governing Council decision-making now is relatively smooth because the Euroland average is dominated by 6 nations whose macroeconomies run pretty much in synch.

Figure 15: Possible Coalitions in the Governing Council



	Executive Board (EB)	EB+Core 7	Tot Less Sync'd
ECB 18	33%	72%	28%
ECB 23	26%	57%	43%
ECB 30	20%	43%	57%

Note: The last two columns add to 100%. The 1st bar is the ECB18, 2nd bar is ECB23 and 3rd ECB30.
Core 7 = D, F, I, NL, B, L, A.
Less Synchronised = Ire, P, E, Fin, Gr & Entrants in ECB23 & 30
Source: Authors' Calculations (ECB_reform.xls).

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 13 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 Euroland averages.

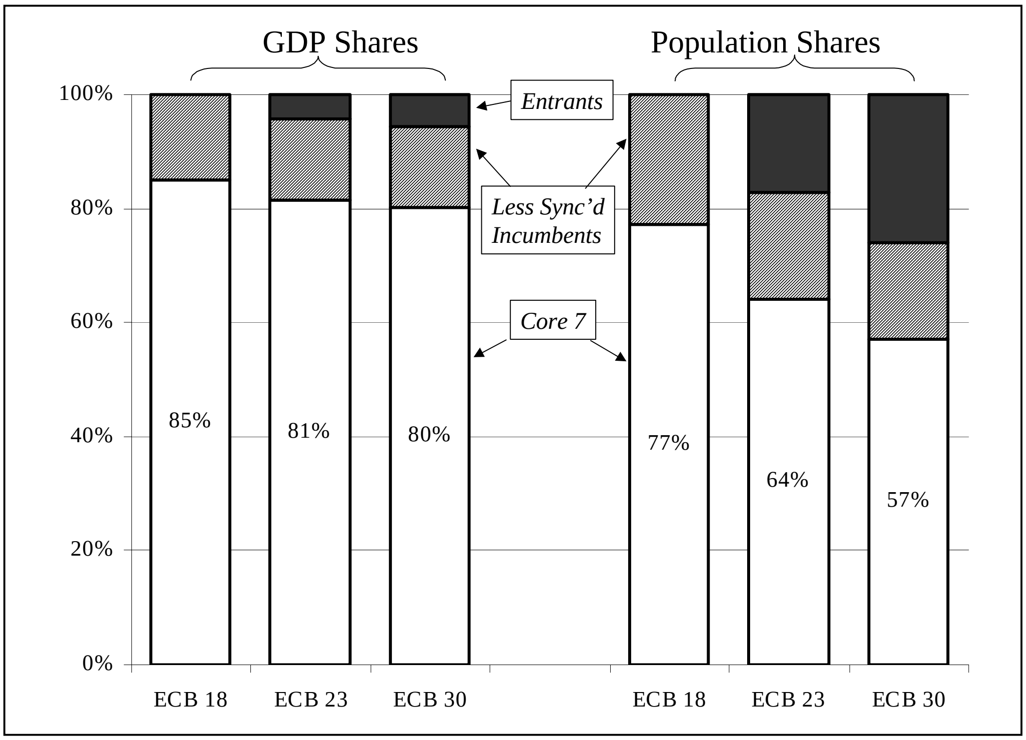
Figure 15 shows the evolution of a blocking coalition made up of the 'less synchronised' nations among EU incumbents and applicants. To be concrete, we consider enlargement in two waves and assume that all 12 entrants want to join, but the UK, Sweden and Denmark stay out. This gives us the current ECB 18 and the future ECB 23 (6 Board members plus 12 incumbent governors and 5 governors from the Czech Republic, Estonia, Hungary, Poland and Slovenia), and the ECB 30 (the ECB 23 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 (D, F, I, Benelux, and Austria), 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 synchronised' economies rises to over a half.

Now comparing Figure 15 to Figure 16, we see that the ECB 30 would find itself in a very unhappy situation. The 16 non-core nations, who together account for only 20% of the Euroland economy would have enough votes to set monetary policy for the whole area.

Simulated reaction to overheating in the core

Figure 16: EMU GDP & Population Shares under Current and Future Memberships



The simple counting of votes, though very transparent, belies the complexity of ECB decision making. According to informal accounts, the President, backed by the EB, sets the agenda. This matters a great deal, as anyone who has tried to oppose a Chairman knows. To be more specific, we view the ECB decision process as follows. The President proposes the interest rate change that is optimal for Euroland (we sweep under the rug any uncertainty about what this is).[7] For short, we call this the optimal Euroland rate change. A vote is held on this and if it does not pass, the President proposes for vote an interest change that is 25 basis points closer to zero change. This continues until a majority is garnered.

On voting behaviour, we assume that the Board votes in unison, and all members always want the interest rate change that is optimal for Euroland. The governors, by contrast, are

[7] Outsider do not know what the precise decision-making procedure, but details do matter, as shown in von Hagen and Supel (1994) and De Grauwe et al. (1999).

viewed as having purely national perspectives and will only vote ‘yes’ for a rate change that is no greater than the one that is optimal for their own nation.

Consider a scenario where the core economies are beginning to overheat, so the nationally optimal interest rate change for core nations is a hefty rise, say 50 basis points. For the Middle nations (not core but still advanced industrial economies) the national optimal change is no more than a 25 basis point rise, and for the newcomers the optimal is no more than a zero rate change. Following the sequential voting procedure, the best the Board can do is to get a 25 basis points rise when the optimal for Euroland would be 0.437 (this is the GDP weighted average of the nationally optimal rate changes).

Note that if instead of sequential voting each governor voted against everything except the nationally optimal rate, the outcome would be no interest rate change since only a coalition of Outer nations and the Board can win.

Instead of purely nationalistic voting, suppose each governor’s preferred interest rate change is an average of the nationally optimal change and the change that would be optimal for Euroland. To be specific, suppose they assigned 50% weight to each their own national optimal and Euroland optimal. In this case, the core nations’ preferred rate change would be 46.9 basis points, the middle nations’ 34.4 basis points and the outer 12 would prefer 21.9 basis points. Even in this case, the outcome would be 25 basis points instead of the optimal 46.9. Clearly, if each governor put 100% weight on the Euroland optimal, the decision would be unanimously in support of the Board’s position.

6. How Should the Statutes of the ECB Change?

Before discussing alternative proposals, it is worth pointing out a caveat. We have marshalled what we feel are strong arguments for restructuring the EMU before enlarging it. These arguments provide some hints as to what changes should look like, but not the full solution. The detailed study of EMU reform is difficult at this point because we do not really know how the system works now, and we have even less information on how it is likely to work with a dozen more members. Consequently, we shall discuss what should characterise a good set of changes rather than pushing a specific proposal.

Reform Evaluation Criteria

Any change must restore the ECB’s capacity to take tough decisions fast and at the right time. Basically, this boils down to at least maintaining the current voting share of the Executive Board. It must also maintain, and hopefully re-enforce the system’s legitimacy. As part of this, we note that the composition of the ECB decision-making body, the 6 EB members plus the 12 NCB governors, is manifestly the result of a compromise between national interests/perspectives and a euro-wide perspective. While this structure will no longer work with even 5 more members, it is important to keep in mind the balance that motivated the current structure.

We can also discuss the shortcomings of one obvious model. The Federal Reserve Open Market Committee (FOMC) cannot be a model for the ECB. Rotation among central bank governors is unrealistic and potentially divisive. It is unrealistic to ask the president of the Bundesbank to leave his seat to the Central Bank governor from Malta; it is equally divisive to give her a permanent seat.

Perhaps the simplest solution to the decision-making efficiency problem would be to assign monetary policy decisions to the Executive Board, either by removing the Central Bank governors from the Governing Council, or by taking monetary policy out of its remit. This step would look the natural one the day the Commission also changed removing the one-Commissioner per member state rule. Until that happens simply removing NCB governors from monetary policy decisions may be unrealistic, since it would destroy the current balance between national and euro-wide perspectives.

One option is to leave the governors on the Council, but without voting power. This would safeguard one aspect of the Bank's democratic-accountability (one national from each Member State could attest to the quality and seriousness of the deliberation and ensure that each national perspective got a hearing). A less radical alternative would be to double the number of votes per Executive Board member while maintaining the one-vote per governor rule. Another radical proposition would be to weight the votes of national Central Bankers by their GDP shares and ask them to take a national perspective. The weighted vote in this rather naïve alternative would reflect the Euroland average.

By far a better alternative – but one which requires a good deal of determination on the part of politicians – involves the Council and Parliament more closely (after all both have a major say in any Treaty change). This scheme would assign monetary policy-making to the Executive Board exclusively, but, by way of maintaining the national-versus-euro balance of perspectives, one can imagine allowing the Ecofin Council to set the overarching guidelines, the inflation target in particular, while assigning the execution of monetary policy to the Board (an arrangement introduced in the UK when the Bank of England was made independent) . Under the 'flag' of democratic accountability, the treaty could expand the role of the European Parliament's oversight powers. For example, perhaps the Parliament could have the same 'nuclear deterrence' it has with the Commission. Right now, the Parliament can fire the whole Commission but not individual Commissioners. This formal power has not been used and is unlikely to be used, but its existence does wonders for the Commission's responsiveness to the Parliament's concerns. When extending this to the ECB, one might like to make this recourse even more difficult to use, by, for example, requiring three-quarters of the Parliament and a qualified majority of the Council.

7. Restructure EMU Before EU Enlargement

The above reasoning indicates that enlarging an unchanged monetary union could have grave consequences for EMU monetary policy making and this suggests the urgency of restructuring the monetary union before it is expanded. It should also be clear that this should take place before the next EU enlargement.

The reasons are simple. New entrants will almost surely view the necessary changes as a retraction of newly granted powers. Since they will have a veto of such changes (most of which require Treaty revisions), it will be much harder to get any such measures passed after EU enlargement. Moreover, as mentioned above a very natural price that the CEECs might require would be a lenient judgement on the Maastricht criteria ('you can change it, if we can join it'). The idea of such a bargain would do little to bolster the euro's status. Moreover, discussing change 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 specific change should be made before enlargement. If a view were to emerge that the new, tighter criteria should be adopted, then this should be decided now, and the treaty modified accordingly.[8] 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.

8. The Advantage of Admitting the Obvious: EMU as the Case Study of a Re-enforced Co-operation Area

One important decision that will be taken in Nice is whether to allow 're-enforced co-operations' (RCs) to be set up also in the areas falling under the First Pillar, essentially the single market and EMU. Until now, under the Treaty of Amsterdam, First Pillar policies were excluded from 'closer co-operations'. This step would force the Union to face a fact that so far it has been unwilling to accept. Since the Danish referendum of last September, when Danish citizens voted against adopting the euro, EMU has de-facto become an area of 're-enforced co-operation.' There is no benefit from denying this – it undermines the credibility of the EU as a democratic institution, and does not help running EMU effectively. Thinking about EMU as an area of re-enforced co-operation has an additional benefit; it provides a case study for the design of an RC. The process of European integration has always advanced in steps. The single market evolved from the experience of running the common agricultural market and EMU itself was the natural evolution of the EMS.

EMU already shares many of the characteristics an RC should satisfy. It deals with a policy area that exercises strong gravitational effects, namely it tends to attract outsiders, thus safeguarding the long run unity of the EU. [9] The euro and the ECB will eventually foster a single financial market, so staying out will become increasingly costly. [10] Moreover, entry

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[8] For example, one might think of raising the standards of compliance with the Maastricht convergence beyond a single year or two, requiring, for instance a demonstrated ability to keep within the Maastricht limits for a period, say of two years.

[9] A useful set of ideas for how to reconcile the flexibility that is needed even in the First Pillar, with the long run objective of unity, has been proposed by Kölliker (2000). As opt-outs from an RC are in principle unlimited in time, the only way to safeguard long run unity of the EU is to allow RC's only in cases where the policy area exerts a strong attraction on outsiders. The paper by Kölliker provides a general framework for identifying policy areas likely to produce gravitational effects, drawing from the theory of public goods.

[10]The EMS experience provides a good example of an arrangement that exerted strong gravitational effects: at the beginning the exchange rate mechanism was not even part of the EU: it was an agreement among central banks. Eventually it attracted all EU states.

rules for newcomers into EMU are pre-determined and non-discriminatory, another important characteristic RCs must satisfy in order to avoid such co-operations being perceived as discriminatory.

The particular area in which EMU could provide a useful testing ground for how to run an RC is administration, and here we have in mind the problems currently faced by the so-called Euro Group. The Group has evolved, parallel to Ecofin, from the need of finance ministers from EMU-member countries to share a forum in which to discuss fiscal policy and its co-ordination with monetary policy [11]. Currently the Group is uneasy and lacks proper preparatory work: *uneasy* since it is unofficial, and *ill-briefed* because it lacks a secretariat. Identifying the Euro Group as one of the administrators of EMU (the other being the ECB) and creating a technical body to support it would solve both problems. The technical body could be structured along the lines of the Economic and Financial Committee (EFC), which uses the Commission services for its secretariat--but in which agenda setting power does not rest with the Commission. Giving institutional status to the Euro Group would also facilitate its interactions with the ECB.[12]

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[11] On the Euro-group and its relations with the ECB, see ECB 'The ECB's relations with institutions and bodies of the European Community', Monthly Bulletin, October 2000.

[12] The idea of using the provision of the Treaty of Amsterdam dealing with close co-operation to institutionalise the Euro group has been explored in Pench (2000). On this see also Jacquet and Pisani-Ferry (2000).

PART 3

A Sequence of 'Examination' Dates for Enlargement Should be Set in Stone

9. Further Reform Should be a Priority, Not a Condition

Simple political logic tells us that some institutional reform must be accomplished before enlargement. EU leaders have focused on Commission and Council reform, and above we argued that the ECB must also be restructured before enlargement. Others will surely add to this reform-before-enlargement list in the near future since there is little chance that a Treaty will be signed in Nice (the legal text will not be ready).

To cynics, this lengthening list is an enlargement-delaying stratagem. More importantly, making further EU internal reform a condition for enlargement gravely undermines the CEECs' transition process, which in turn could damage the harmony of the eventually enlarged Union.

There is an uncomplicated way to reconcile the 'reform imperative' and the 'accession imperative.' *The EU should make reform a priority rather than a precondition*. Practically, this could be accomplished by a firm commitment in Nice to dates – not accession dates, but Maastricht-style dates that lock in: (a) the first date for evaluating which nations are ready to join, (b) the date on which accession Treaties would be signed for those who passed the evaluation, and (c) the dates of subsequent evaluations and signatures.

In what follows, we first study the role of dates in encouraging CEEC transitions. 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 Closer Co-operation arrangements, which pose entry criteria above and beyond accession criteria, would also foster continued CEEC transition efforts.

9.1. The Dating Game: Impact of the Nature and Sequence of Dates

The date issue is complex, so a framework for organising our thoughts is useful. 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 test impose 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 MD, (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.

Perhaps a closer analogy comes from the Maastricht Treaties 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 nonEMUers 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 Union 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 this condition. 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 more explicit and convincing. Recent attempts to involve the Directorate 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', also creates uncertainty about the size of the prize. The applicant countries have legitimate concerns that they will join the Union as second-class citizens deprived of many of the membership benefits.

But a multi-speed Europe may also serve to strengthen the enforcement powers of the Union once countries are inside. So far we have argued that these powers are weak, and that they may be further weakened after an Eastern 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 has to try to meet the conditions imposed by the Maastricht Treaty.

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 or 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 a 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.

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