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ABSTRACT

The European Union is at a crossroads. At issue will be each of the three decisions which define a federal constitution: the number of participating governments, the assignment of policy responsibilities to the new EMU, and the representation of local interests in, and the decision-making rules for, the Union. Subsidiarity is to be the guiding principle. This essay reviews three alternative models of subsidiarity -- decentralized federalism, centralized federalism, and democratic federalism -- and argues the current European Economic Community has evolved from decentralized to centralized to a fully democratic federalist state. The structure of EMU governance is in place and it closely resembles that of the United States: an institutionally weak executive, a country-specific Council of Ministers and a locally representative Parliament. The remaining issues to be decided are the number of participating members and the assignment of policy responsibilities to levels of government. A large Union with significant fiscal policy responsibilities is likely to replicate U.S. economic policy performance.

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SUBSIDIARITY AND THE EUROPEAN UNION

by

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Subsidiarity is a principle of governance designed to give meaning to the divisions of power and responsibility between the central government and constituent states in a federal system. The principle seeks to allocate responsibilities for policy formation and implementation to the lowest level of government at which the objectives of that policy can be successfully achieved. Today's proponents of subsidiarity within the European Union trace its intellectual roots to 20th Century Catholic philosophy:

> Just as it is wrong to take away from individuals what they can accomplish by their own ability and effort and entrust it to a community, so it is an injury and at the same time both a serious evil and a disturbance of right order to assign a larger and higher society what can be performed successfully by smaller and lower communities. . . . (T)he more faithfully this principle of subsidiarity function is followed and a graded hierarchical order exists among the various associations, the greater also will be both social authority and social efficiency, and the happier and more prosperous too will be the condition of commonwealth (Pius XI as quoted in Bermann 1994, fn. 18).

The task before those writing constitutions of the federal form for the European Union is to give meaning and content to the principle of subsidiarity. To do so requires, first, a clear articulation of the objectives of government, and second, a clear understanding as to how alternative federal constitutional structures might foster those objectives. A principle of subsidiarity then weighs these potentially competing objectives and in the process selects that federal constitution form which best promotes the desired balance.

The Objectives of a Federal Constitution

Constitutions establish the rules for collective decision-making: who is allowed to participate, what is to be decided, and how those decisions are to be reached and enforced. The unique contribution of a *federal* constitution is to allow for multiple layers of governments, each with a domain of policy responsibilities. In setting the number and layers of governments and in drawing their exclusive and mutual responsibilities, three objectives for government are commonly mentioned: the guarantee of personal, political, and economic rights; the encouragement of political participation; and the promotion of the efficient allocation of economic resources.

Protecting Rights: Personal, political, and economic rights define the domains of individual liberty. Liberty may be either negative or positive (Berlin 1958). Negative liberty ensures that individuals are free from interference of others in certain choices and actions; positive liberty guarantees each individual an ability to make certain choices or to perform certain actions. Religious rights, voting rights, free speech, and property rights are examples of protecting negative liberties. A right to minimal subsistence and shelter, to education, or to health care provide protection for our positive liberties. Governments in turn protect rights and the constitution defines how that role will be exercised. Specification of a Bill of Rights joined with a credible and independent judiciary is perhaps the most important institutional guarantor of individual rights. Separation of powers between branches of the central government joined with credible checks and balances across those branches offers further protection. Federalism is a possible third line of defense.

Encouraging Political Participation: Political participation involves actions through

which ordinary citizens influence or attempt to influence political outcomes. The potential benefits to citizens from political participation are threefold: instrumental or utilitarian, developmental or educative, and intrinsic or consumptive. For utilitarians such as Bentham and James Mill political participation serves a specific function: To ensure that government maximizes aggregated citizen utility or welfare. While acknowledging the contribution of participation to efficient government, Rousseau and John Stuart Mill stress the role political participation can play in protecting citizen liberties. Through participation no one individual or group is master over any other. Finally, for Aristotle, Rousseau, J. S. Mill, de Tocqueville, and contemporary commentators such as John Dewey, political participation serves important communitarian values (Frug 1980). By participating in the political process an individual learns that his private interests are intimately linked to the interests of others, leading to a willingness to compromise, to put private interests aside, and to call upon values of justice and common good when making public and private choices. The federal form of government, giving an important policy role to local jurisdictions, may encourage participation. In small governments, each vote is more likely to be pivotal to the policy outcome, access to politicians is likely to be easier, and information about politicians' activities is likely to be more readily available. Smaller governments are likely to give each individual citizen more political influence over outcomes, and increased political influence is likely to stimulate increased individual political effort and participation.

Promoting Economic Efficiency: Economic efficiency seeks to ensure that there is no reallocation of society's economic resources which can make someone better off while leaving everyone else no worse off. Competitive markets are the preferred institution for ensuring

economic efficiency, but markets do not always achieve this end. Markets fail for a variety of reasons: public goods, spillovers, increasing returns to scale, and asymmetric information. In each instance, economic efficiency requires cooperative behavior to provide a shared asset, and each economic agent must reveal his or her true preferences for the shared good. Markets, however, are often incapable of assuring truthful revelation in these cases; each market participant can successfully understate their benefits from the provision of the shared good. Thus if a market supplier provides the good, cost go uncovered, but alternatively, if no supplier offers the good, demands go unmet. One institution which can both cover costs and meet demands for public goods -- albeit through coercion -- is government. Government, however, must solve the same problem of truthful revelation which undermines market performance. The federal form of government offers two means to solve the revelation problem: A system of competitive, decentralized local governments and a democratically elected national government. Which form of government is used need not be an either or choice, for both are available with a federal constitution. The logic of subsidiarity is offered to help us choose.

The Structure and Performance of Federal Constitutions

All constitutions must define who is allowed to participate in governments' decisions (citizenship), what governments can and cannot do (personal and economic rights), how governments' decisions are to be made (political rights and voting rules), and how governments' decisions are to be enforced (judicial rules). Federal constitutions must also be defined along three additional dimensions: the number of lower tier, or local, governments in the federal union, the assignment of policy responsibilities to local and national governments, and the

representation of local jurisdictions in the national government. Three alternative federalist constitutions can be specified.

Decentralized Federalism: Decentralized federalism combines Charles Tiebout's (1956) competitive model of government with Ronald Coase's (1960) model of efficient bargaining. Using the arguments of Tiebout, the number of local governments is set equal to that partition of a population which can provide the most congestible "local" public good as efficiently as possible. Examples of congestible public goods -- goods where more users eventually reduces the benefits enjoyed by previous users -- include education, police and fire protection, health care, highways, parks, libraries, communication networks. The efficient community size for the most congestible local public goods is about 20,000. Assignment in decentralized federalism allocates all policy responsibilities, at least initially, to these local governments. Local governments may jointly decide to allocate some or all of their policy responsibilities to a central government. Decisions to allocate policy centrally, and deciding what those policies should be, will be made by a national legislature. Representation to this national legislature will ensure at least one representative for each local government. Following the logic of Coase bargaining, unanimity is the required voting rule in this legislature.

As a protector of individual rights, the performance of decentralized federalism is uncertain. If individuals are mobile across local governments, if new local governments can be easily established, and if local governments have full responsibilities for rights enforcement and policies, then individual rights to personal freedoms, political rights, and property rights are likely to be well protected. Nonetheless, a strong central government will be required to ensure an individual's right to move freely, to allow new communities to incorporate, and to guarantee

that each community can set and enforce its own policies. If free mobility, community formation, and community independence cannot be guaranteed by the central government, then local governments may become a source of oppression through "tyranny by a majority." U.S. Southern states before the Civil War is one telling example. Decentralized federalism may also fail to ensure positive liberties. If protecting positive liberties requires the taxation of the more able to subsidize the less able -- say to provide a subsistence income, basic shelter, or minimal education and health care -- then a decentralized network of fiscally competitive local governments is not likely to succeed; this protection is likely to come only from a central government. But under decentralized federalism central government policy requires the unanimous consent of all local communities. Positive liberties are denied, now through "tyranny by a minority."

The likely performance of decentralized federalism in fostering political participation is more encouraging. Available evidence reviewed by Dahl and Tufte (1973) from within country comparisons of political influence and political effort shows that citizens in smaller governments make a greater effort to understand, and have more success in understanding, local rather than national political issues. Further, citizen efforts to influence government is two to three times higher for local than for national governments. Political effectiveness or influence also increases as the size of government declines; Finifter (1970) shows a significant negative correlation between an index of political power and the size of government. Finally, locally elected legislatures are likely to be the most responsive to citizen preferences (Cain, et al. 1987).

The potential for decentralized federalism to efficiently allocate public resources is also uncertain. Five conditions must hold for the decentralized public economy to be economically

efficient: 1) Publicly provided goods, services, and regulatory activities must be provided at minimum average cost; 2) There must be a perfectly elastic supply of political jurisdictions, each capable of replicating all attractive economic features of its competitors; 3) Households and businesses must be fully informed about the fiscal and regulatory policies of each jurisdiction; 4) Mobility of households and businesses among jurisdictions must be costless; and 5) There can be no interjurisdictional externalities or spillovers. When condition 1 is violated, the community's activities become "public goods." Without condition 2, fiscal competition can lead to the misallocation of labor and capital (Boadway and Flatters 1982). If families and businesses do not know the full implications of government policies (violating condition 3) or if there are significant relocation costs (violating condition 4), then the current community can "exploit" residents and firms through higher taxes or lower services. Finally, when there are inter-community production or consumption spillovers (violating condition 5) local services may be under-provided (positive spillovers) or over-provided (negative spillovers). The solution in each case is to look to a central government to manage the resulting misallocations.

In decentralized federalism, Coase bargaining is the approach used to set central government policies. For successful Coasian bargains to occur, five conditions must be met: 1) There must be no, or very small, resource costs associated with the bargaining process; 2) Preferences over bargaining outcomes and the resources of households must be common knowledge; 3) Bargaining agents must represent fully the economic interests of their constituents; 4) All bargaining agreements must be costlessly enforceable; and 5) The parties must agree to a division of the bargaining surplus. Condition 1 seems defensible. The agents for bargaining -- elected local government officials -- are already in place in the Tiebout

economy; the marginal costs of using these representatives to negotiate additional political agreements are likely to be small. Meeting conditions 2-5 seem more problematic. If the preferences of each local representative to the central government are not common knowledge (violating condition 2), then there will be strategic advantages to concealing true benefits and costs and no agreement may be forthcoming (Crawford 1982). There is no guarantee that an elected local representative will choose to represent that group harmed by an inefficient out-of-state policy if the affected citizens are a minority; condition 3 is then violated. Failure to enforce inter-community bargains (violating condition 4) is likely to be problem only when important contingencies which might affect the agreement cannot be foreseen in advance, creating incentives to break a necessarily incomplete contract at a later date. Such behavior also discourages initial agreements. Finally, local representatives may not be able to agree on how the economic surplus generated by inter-community exchange should be divided (violating condition 5). One jurisdiction can reject an economically beneficial offer from another jurisdiction simply because the proposed offer, even though efficient, violates the first's community's exogenous, and no doubt politically motivated, sense of economic fairness (Roth 1985). The hope that voluntary inter-community Coasian compacts might ensure an efficient allocation of resources when the Tiebout economy fails seems optimistic. A centralized federal constitution offers an alternative.

Centralized Federalism: Centralized federalism combines local governments with a central government run by an elected president or executive council. All policy responsibilities are assigned initially to the central government. If the elected president or council wishes, those responsibilities may be reassigned to local governments.

Centralized federalism is likely to offer only fragile protection for individual rights. When the majority electing the executive is a stable majority, either because of stable economic interests or ethnic allegiances, the place and prospects of immobile minority groups is solely defined by the ruling majority. The fate of Blacks in the U.S. South before the Voting Rights Act of 1965 and that of Jews in Nazi Germany illustrate the potential risks to basic liberties with strong, majority-controlled central governments.

Nor is centralized federalism likely to enhance the goal of political participation. The constitution concentrates all policy responsibilities at the central government level. Powers can be decentralized if the executive so decides, but this seems unlikely if the executive's re-election prospects depend upon fulfilling campaign promises. Local governments, arguably the most participatory of all governments, may become no more than administrative agencies of the center. Nor is political participation at the center likely to be very great, limited as it is to the election of a single executive.

The goal most likely to be encouraged by centralized federalism is economic efficiency. Here a democratically elected executive sets policies for the nation as whole. For these policies to be efficient, however, the executive must first reveal citizen preferences for public goods. While demand-revealing mechanisms can be specified to elicit true preferences, such mechanisms are themselves costly and are only guaranteed to work when citizen preferences are additive separable between income and the public goods (Laffont 1987). Nor is there any guarantee the executive will choose efficient policies even if all citizens' preferences are known. In centralized federalism, there is no credible means for the executive to commit to such a policy. The burden for finding an efficient resource allocation falls to the election process. If elections are open so

that any citizen can run for the presidency and if all citizens (more generally, all preference types) are equally capable in managing government and these management skills are public knowledge, then policies chosen by the president will be efficient in two candidate elections (Besley and Coate 1997). The intuition for this result is straightforward. In two candidate elections, citizens vote truthfully; thus, any efficient candidate can propose a policy which benefits herself and a majority of other voters and defeats any policy proposed by an inefficient candidate. If these conditions do not hold, however, and in particular if elected officials can hide their dishonesty or incompetence, then efficiency is not assured (Coate and Morris 1995). Open elections and full knowledge of the performance of candidates are required.

Democratic Federalism: Democratic federalism offers a possible middle ground upon which to balance the advantages of a decentralized federal constitution for protecting rights and promoting participation and the advantages of a centralized federal constitution for efficiently providing public goods and local spillovers. The number of local governments is set so that local congestible public services are efficiently provided. Constitutional assignment can be to either local or central levels of government. Finally, representation in democratic federalism can be structured to give local interests a clear voice in central government policy-making through representation to a locally elected national legislature. Under democratic federalism, decisions by the central government legislature are made by majority-rule.

Democratic federalism may assign policy responsibilities to local and central levels of governments according to how those assignments might make the strongest contribution to ensuring personal, political, and economic liberties. For example, assigning significant taxing powers to local governments controls the unwanted government taking of private property by

government (Brennan and Buchanan 1980 and Weingast 1995). Assigning local governments responsibility for police functions ensures that local residents can monitor and discipline any abuses of police powers and provides possible protection against armed interventions by other local or even national interests (Rapaczynski 1986). Education too -- particularly control over the curriculum -- could be assigned locally to ensure political rights and freedom of speech. The central government can then be given responsibility for ensuring minimal economic subsistence, access to clean and safe shelters, literacy, and basic health services (Sen 1988). Finally, a representative legislature run by majority rule checks tyranny by a stable minority, while wide representation of local interests minimizes the risks to rights arising from a stable majority (Madison Federalist 10).

Political participation is also likely to benefit from the introduction of democratic federalism. To achieve this potential, however, local governments must be assigned significant policy responsibilities (Dahl and Tufte 1973), and the central government's legislature must allow for significant representation of local interests (Cain, et. al. 1987).

The efficiency performance of democratic federalism turns on constitutional assignment and representation. As a guideline to assignment, local governments will be most efficient for those services, taxes, and regulations which benefit local populations and which have no significant positive or negative spillovers onto non-residents. For goods with significant economies of scale in production or consumption, for taxes which alter the spatial allocation of economic resources, and for services and for regulations with economic spillovers, allocation by the central government is preferred (Oates 1972).

Democratic federalism adjusts representation to the central legislature to improve the

efficiency performance of the central government in allocating its assigned tasks. Representative legislatures must overcome a fundamental structural defect of democratic choice: the propensity of the majority-rule process to cycle from one policy outcome to another (Arrow [1951] 1963). If legislatures are to reach decisions, additional legislative institutions must be discovered for overcoming this inherent instability. In democratic federalism a norm of deference may arise to control such instabilities (Weingast 1979). Each legislator defers to the preferred policies of all other legislators, provided the other legislators defer to the legislator's own policy requests. Unfortunately, large legislatures operating under a norm of deference run a significant risk that their chosen policies will be economically inefficient. In a national legislature financed by national taxation there results a cross-subsidy from taxpayers nationally to the residents of the jurisdiction receiving the centrally provided public good. The incentive for the legislator selecting a project and facing such a subsidy is, of course, to ask for too much of the good. In one important instance, however -- the case of Samuelson public goods or goods with positive spillovers -- the incentive for local representatives to demand too much of the good may promote efficiency. In this case, the legislature's cost-sharing of local projects encourages local representatives to demand more of a nationally beneficial public good than they would if they had to finance the good on their own. Tax-sharing in the national legislature acts as a subsidy for local representatives to provide more of nationally beneficial public good. As a guideline to representation in democratic federalism -- precisely efficient representation is generally not possible with multiple public goods -- the legislature should approximate in size the average ratio of national to local benefits for the public goods and spillovers it has been assigned (Inman and Rubinfeld 1997). Under this guideline, central government legislatures

assigned responsibility for important national public goods should be large, while legislatures assigned responsibility for local goods should be small.

The European Union's Search for a Federal Constitution

The European Union is at a crossroads. The Maastricht Treaty on European Union (TEU) has set April 30, 1998 as the date at which the Union's members will reach a decision as to whether to extend the current cooperation on internal market affairs to aggregate monetary policy and if so, which countries will be allowed to participate in this new Economic and *Monetary* Union and the conversion rate for national currencies into Euros. At issue will be each of the three decisions which define a federal constitution: the number of participating governments, the assignment of policy responsibilities to the new Economic and Monetary Union, and the representation of local interests in, and the decision-making rules for, the new European Monetary Union (EMU). The final choice of the EMU's constitutional form will involve an inevitable balancing among the three potentially competing objectives of the federal form of government: protecting rights, encouraging political participation, and promoting economic efficiency.

The Road to Maastricht: Beginning with the 1951 Treaty of Paris between France, West Germany, Italy, Belgium, Luxembourg, and the Netherlands establishing the European Coal and Steel Community, to the 1957 signing in Rome of the European Economic Community Treaty (Treaty of Rome), to the Luxembourg Compromise in 1966, to the entrance of Denmark (1973), Ireland (1973), United Kingdom (1973) and Greece (1981) into the Community, and finally to the further addition of Spain and Portugal and the signing of the Single European Act in 1986,

the nations of central Europe have been moving steadily, albeit slowly, towards an integrated economic and political union. The central driving force both historically (Bulmer 1994) and to this day (Bednar, Ferejohn, and Garrett 1996) has been the desire of France and Germany to avoid military conflict on the continent. Integrated economies are seen as one crucial means for ensuring political stability in Europe.

Governing the initial steps towards this economic union has been a federal constitution best described by *decentralized federalism.* The Treaty of Rome created a variety of supranational institutions akin to a central government, the most prominent of which were the European Commission serving as an executive civil service, the European Parliament serving as an elected (since 1979) legislature but with consultative powers only, the Council of Ministers whose final *unanimous* approval (until 1966 when qualified majority was to take affect) was required for all EMU decisions, and the European Court of Justice who made rulings on matters of treaty enforcement. The center of power lay with the Council of Ministers composed of one representative from each member state and guided, since 1974, by a complementary body of heads of state called the European Council. While the Commission as executive was formally given the right to propose legislation in the Treaty of Rome (Article 155), it lacked power to keep items off the agenda, and more importantly, could not constrain the Council from acting unanimously to amend its proposals (Article 149). Beginning in 1966, the Treaty required a formal change in Council voting procedures, moving the decision-making rule from unanimity to qualified majority. However, a threat by France to withdraw from the Council of Ministers if qualified majority took effect lead the Council to adopt the Luxembourg Compromise to continue a rule of unanimity on all matters of "vital national interest." While not formally part

of the EEC Treaty, the Compromise has stood as a binding constraint on Council decisions until the passage of the Single European Act in 1986. Members of the Council of Ministers vote according to national interests. As a consequence the Luxembourg Compromise meant only Coasian agreements could become Community policies.

The Treaty of Rome also established the assignment of policy responsibilities to the Council, foremost of which was to create a common market. This the Council did through its power to remove intercountry tariffs (Title I) and through the promotion of economic competition between firms in member countries (Articles 85 and 86). The Council also assumed responsibility for a Common Agricultural Policy adopting a variety of price support policies "to ensure a fair standard of living for the agricultural community (Article 39)." In all major instances these policies were approved by a unanimous Council of Ministers. Also assigned to the Community for policy development were transportation policies and social policies. Because of significant disagreements among member countries in these policy areas, however, unanimity was not achieved and little could be accomplished towards overall goal of economic integration.

Born in part from the frustration over the slow pace of integration and a growing appreciation of the advantages such reforms might have in combatting Europe's declining economic fortunes (known as "Eurosclerosis"), the ten members of the Community put aside the Luxembourg Compromise and decentralized federalism and adopted in 1986 the Single European Act (SEA) and a new institutional structure closely approximately that of *centralized federalism*. The rule of unanimity was replaced by a "consultation procedure" and a commitment to allow qualified majorities to make substantive policy decisions. Proposals would come from the European Commission as before. Now, however, only a qualified majority of the Council was

needed for a policy to become law. A qualified majority was defined as receiving 54 votes from a total of 76 allocated as: France, Germany, Italy, and the United Kingdom, 10 votes each; Spain (newly admitted under the SEA), 8 votes; Belgium, Greece, Netherlands, and Portugal (newly admitted under the SEA), 5 votes; Denmark and Ireland, 3 votes; and Luxembourg, 2 votes. Further, the Commission's proposals could be only accepted or rejected; unanimity was required for the Council to amend the Commission proposals. The effect of the consultation procedure was to give strong agenda-setting powers to the Commission; policy-making became centralized in the executive.

The consultation procedure applied to all policy areas covered by the original Treaty of Rome (agriculture, transportation, social policy, environmental policy, regional and fiscal policies) except for those policies concerned with the completion of the internal market (competition policy, free movement of goods, labor, and capital). For this policy assignment, the SEA recommended a second innovation to Community decision-making called the "cooperation procedure." The central difference between the consultation and cooperation procedures is the enhanced role under cooperation for the (now elected) European Parliament. Under cooperation, policies approved by the Council go to the Parliament to be accepted, rejected, or amended by majority rule. If accepted the proposal becomes law. If rejected, the proposal may still become law if subsequently approved by a unanimous Council. If amended, the proposal returns to the Commission which can either reject the amendments (again the proposal dies unless unanimously approved by Council) or return the amended bill to the Council where it becomes law if approved by a qualified majority. The cooperation procedure raises the Parliament to the role of a conditional agenda-setter, where an alliance between the Commission

and the Parliament (a frequent outcome) can force the Council to make decisions on their terms (Garrett 1995 and Tsebelis 1994). The Parliament, however, has no original agenda-setting powers under cooperation, for that it must rely upon the Commission. The pivotal institution for policy innovation under the SEA became the European Commission, an executive cabinet appointed by member nations but charged with ensuring an economically integrated Europe.

The Commission's influence reached its peak in the late 1980's, no more clearly evident than in the 1988 decision to establish a committee under the direction of the Commission President Jacques Delors to explore the feasibility of a European Monetary Union as a complement to the increasingly integrated European marketplace. The resulting Delors Report recommended the creation of a European Monetary Union (EMU) for the member nations of the Community, and in December, 1991 in Maastricht, Netherlands the Treaty on European Union (TEU) was approved, subject to ratification by the citizens of each of the member nations. To this point, the European Commission stood as the dominant voice in Community policy-making, operating much like the strong executive in centralized federalism. Paradoxically perhaps, the approval of the Commission's crowning achievement, the EMU, would begin the significant erosion of its powers and the evolution towards democratic federalism under Maastricht.

Maastricht: The Maastricht Treaty creating the Economic and Monetary Union seeks to continue the (now) Union's move towards the free flow of goods, labor, and capital and to establish a common monetary policy for all member states through the introduction of a single European currency and a single European Central Bank. It remains a controversial objective. The promised benefits of the Monetary Union are fourfold: 1) Lower transactions costs of doing business in the Union because of a common currency; 2) Price stability because money supply

will be controlled by politically independent European Central Bank; 3) Increased trade because of reduced currency risk from the common currency; and 4) Increased capital formation again because of reduced currency risk. However significant, and recent evidence suggests the economic benefits may be small (Eichengreen 1993), they come at a potential cost. Countries joining the Union will sacrifice their ability to use expansionary monetary policy to offset the adverse employment effects of negative economic shocks. If economic shocks affect all or most of the Union's countries similarly, then the EMU's common monetary policy can serve the same role as country-specific expansionary monetary policies during times of deep recessions. But if economic shocks are asymmetric across the potential members of the EMU, as the evidence seems to indicate (Bayoumi and Eichengreen 1993), then the loss of country-specific monetary policy imposes potentially large costs on members during economic downturns. The costs are likely to be largest in the larger countries of the Union, where domestic monetary policy now has significant stimulatory benefits during recessions.

One answer to these concerns is to allow member countries -- now expanded to include Austria (1995), Finland (1995), and Sweden (1995) -- to run decentralized, country-specific deficit fiscal policies. But Maastricht, as recently amended by the inclusion of a Pact for Stability and Growth, will deny member countries this policy assignment. Concerned that economic spillovers from high deficit countries would threaten promised price stability in EMU monetary policy, the Stability Pact imposes tight limits on allowed deficits. Countries included in the EMU must maintain an overall budget deficit for each fiscal year equal to or below 3 percent of GDP. If this target is not met, the violating country will be required to make a non-interest bearing deposit of .2 percent of GDP up to a maximum of .5 percent of GDP for

increments in deficits above 3 percent. If deficits do not fall within two years, the deposit is lost and becomes a fine. Only in exceptional circumstances of a more than 2 percent decline in GDP can the deficit regulation be ignored.

Facing constraints on their use of counter-cyclical deficit policies, yet bearing the costs of economic downturns, the members of the new EMU have begun to redesign the political institutions for making economic policies. If member countries are not allowed to run significant deficits, and EMU monetary policy remains committed to the objective of price stability, then EMU (i.e., central government) counter-cyclical measures will be needed (Inman and Rubinfeld 1994). These might include EMU funded and managed unemployment insurance and/or cross-region transfers. Neither policy is precluded by Maastricht and cross-region transfers are now an established EMU policy. Both unemployment insurance and regional transfers are redistribution policies, however. In voluntary economic unions, redistribution policies can only be decided through majoritarian, democratic politics. When compared to the Commission dominated pre-Maastricht institutional structure, member countries rightly sensed a potential "democratic deficit." The Maastricht Treaty was responsive to this new democratic reality in two ways: First by constraining the Commission as an executive through the logic of subsidiarity and, second by significantly expanding the role of the European Parliament through a "co-decision" procedure.

Subsidiarity as principle of governance, articulated for the Maastricht Treaty by the 1992 Edinburgh Summit, permits the Community to act only if the objectives of the Community's policies "cannot be sufficiently achieved by Member State action (and) can . . . be better achieved by action on the part of the Community" (Edinburgh Summit cited in Bermann 1994

p. 369). The Commission has taken this directive to heart, recasting or cancelling hundreds of existing regulations and dropping several of the Commission's previously favored legislative initiatives (Bermann 1994 p. 378, 381).

The co-decision procedure, introduced in the Maastricht Treaty (Article 189b) and amended by the 1997 Treaty of Amsterdam, elevates the European Parliament as the locally elected body in the Union's decision-making structure to equal legislative standing with the Council of Ministers. The 1986 SEA created the cooperation procedure in which the Parliament could accept, reject, or amend Council decisions. Under cooperation, however, rejected and amended decisions returned to the Council for final decision, and the Parliament had no further say in policy choice. At best the Parliament was an agenda-setter, but only if the Commission as the true agenda-setter acquiesced. Maastricht's co-decision procedure now gives the Parliament joint say along with the Council of Ministers over the final specification of all EMU policies except monetary policy. Policies rejected or amended by Parliament but once again approved by Council, perhaps in another amended form, must now be agreed to by an absolute majority of Parliament. Disagreements between the Council of Ministers and Parliament are to be resolved through a Conciliation Committee composed of members from both bodies. Committee compromises return to their respective chambers, using a qualified majority in the Council and an absolute majority in the Parliament for final approval. The net effect of the co-decision procedure has been to create two equally powerful legislative bodies, each capable of blocking the preferred outcomes of the other. Under Maastricht, negotiations between a broadly elected Parliament and a country appointed Council replace the non-elected Commission as the center locus for EMU policy-making. The EMU decision-making structure now closely

resembles that of the United States: an institutionally weak executive, a state (country-specific) Senate and a district (local region-specific) House. It is the constitutional form of *democratic federalism*.

After Maastricht: The EMU stand at a crossroads. Having put in place the political institutions of democratic federalism -- broadly representative legislatures governed by majority rule -- two constitutional decisions remain to be decided. Which countries will participate in the new Union, and what policies will become the responsibility of this new EMU central government. How these remaining constitutional decisions are resolved is likely to have significant consequences for the eventual economic performance of the new Union. A large Union with significant EMU fiscal policy responsibilities runs the risk of replicating current U.S. policy performance and its associated fiscal inefficiencies following from norm of deference budgeting (Inman 1988 and Inman and Fitts 1990). A small Union with EMU policy assignments limited to monetary policy and the regulation of the internal market has the potential to maintain current economic gains (Emerson et al. 1988) and to encourage new, welfare-improving cross-national agreements where appropriate (Dewatripont et al. 1996). Which path will be chosen, and in the end provide the true meaning of subsidiarity for the European Monetary Union, remains to be seen.

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