



THE LONDON SCHOOL
OF ECONOMICS AND
POLITICAL SCIENCE ■



LSE 'Europe in Question' Discussion Paper Series

Good Governance in Crisis or a Good Crisis for Governance?

A Comparison of the EU and the US

Waltraud Schelkle



LEQS Paper No. 16/2009

December 2009



Editorial Board

Dr. Joan Costa-i-Font

Dr. Vassilis Monastiriotis

Dr. Jonathan White

Ms. Katjana Gattermann

All views expressed in this paper are those of the author and do not necessarily represent the views of the editors or the LSE.

© Waltraud Schelkle



Good Governance in Crisis or a Good Crisis for Governance?

A Comparison of the EU and the US

Waltraud Schelkle*

Abstract

The crisis since August 2007 provides an opportunity to observe the workings of good governance institutions under an extreme stress test and in radically different political settings. Institutions such as independent central banks, fiscal rules and regulatory oversight of public finances were meant to depoliticize macroeconomic stabilization. The comparison of responses to the crisis in the United States and in the European Union shows that good governance institutions are in crisis in the US while it has been a good crisis for governance so far in the EU. Levels of fiscal stimulus and monetary easing are surprisingly similar between the EU and the US, yet the ECB has maintained its independence and member states have been restrained from inserting protectionist elements in their stimulus measures. By contrast, the boundaries between economic stabilization and distributive politics have been wiped out in the US because neither the political forces in the states nor the economic forces in the financial sector erected many defences. In the EU, the boundaries as drawn are inimical to joint stabilization efforts but this is exactly why they are politically self-enforcing.

Keywords: central bank independence, crisis, depoliticization, European Union, fiscal rules, United States

* **London School of Economics and Political Science**

European Institute, Houghton St, London WC2A 2AE, UK

Email: w.schelkle@lse.ac.uk

Table of Contents

Abstract	
1. Introduction	1
2. Good governance innovations in the EU and the US	3
2.1. Regulatory agencies for fiscal oversight	4
2.2. Fiscal rules	7
2.3. Independent central banks	9
3. The response to the crisis in the EU and the US compared	12
3.1. Fiscal responses	12
3.2. Monetary responses	18
3.3. Regulatory Responses	23
4. Conclusions	27
References	

Acknowledgements

I am grateful for most helpful comments to seminar participants at the bi-annual EUSA conference in Los Angeles on 25 April 2009, as well as to Deborah Mabbett (Birkbeck, London), Vassilis Monastiriotis (LSE, London), Jim Mosher (Ohio State, Columbus) and Fritz W. Scharpf (Max-Planck Institute, Cologne).

Good Governance in Crisis or a Good Crisis for Governance?

A Comparison of the EU and the US

1. Introduction

The financial and economic crisis since August 2007 confronted policymakers with unprecedented challenges. European governments were seen by most observers as responding too timidly. An obsession with institutions of good macroeconomic governance, such as fiscal rules and the separation of monetary from fiscal authority, seemed to contribute to inertia in Europe, as the chief economist of the IMF among others alleged (Blanchard 2009; cf Krugman 2009, Wyplosz 2009). In this view, the EU compared badly with the US government under President Obama which was congratulated for its bold fiscal response, tightly coordinated with monetary policy. Two prominent economists concluded that sacrosanct institutions like central bank independence or fiscal rules have to be abandoned if governments are to stabilize effectively (Buitter 2009; De Grauwe 2009). However, the EU response has proven to be politically robust despite the alleged functional flaws while the response in the US has come under serious political attack in Congress.

The jury on the effectiveness of each response is still out and will be out for years to come. At this stage, the comparison of the responses in the EU and the US provides us with an opportunity to study how major institutions of ‘good governance’ actually worked in contrast to how they were meant to work, in different political settings and under the stress test of the Great Crunch. Economists justified institutions like fiscal rules, independent central banks and regulatory oversight as attempts to ‘depoliticize’ macroeconomic stabilization. They would isolate in particular monetary policy against the influence of electoral or distributive politics

Good Governance in Crisis or a Good Crisis for Governance?

(Kydland and Prescott 1977; Barro and Gordon 1983). Like other manifestations of the 'regulatory state' (Pildes and Sunstein 1995, Majone 1996), these institutions could be justified as correctives to shortcomings of representative democracy, that tends to ignore the outsiders of current electoral politics, such as neighbouring countries or future generations. Institutions of good governance would bring economic rationality to stabilization, a realm of policymaking which should not be ruled by distributive concerns.

But as soon as we recognize that 'depoliticisation' is a misnomer for an eminently political attempt at drawing boundaries between 'pure economics' and 'pure politics', we also recognize that good governance is about empowering certain parts of the political system vis-à-vis others, for instance the executive vis-à-vis legislatures or the central government vis-à-vis lower tiers. Parliaments or lower tiers of government may be willing to agree to this shift of policy-making authority as long as they trust that this can reduce their responsibilities where they feel underequipped to fulfil them. Yet, we should also expect that they remain vigilant that the lines drawn are not encroaching too much on their territory. Hence, where the empowerment of the central executive becomes too obvious or imposing, other political actors will contest the transfer of policy-making authority, try to rein it in or even reverse it. These considerations are crucial for the explanation of what happened to good governance in this crisis.

What happened was that regulatory oversight, fiscal rules, and independent central banks fared in diametrically opposite ways in the responses of the United States and the European Union. Central bank independence and regulatory oversight were effectively abandoned in the US but maintained in the EU, while fiscal rules on state budgets were observed in the US but abandoned in the EU.

In the next section, I summarize how the consensus on good governance was implemented in the EU and the US. The following section will then describe how different the responses in the EU and the US were, but also that the amounts of fiscal stimulus and monetary easing are not as different as the difference in policy inputs leads one to expect. The final section explains these empirical findings in terms of the

political contestation over policy-making authority, rather than depoliticization of stabilization.

2. Good governance innovations in the EU and the US

The institutions analysed here originated in the experience of the 1970s when capitalist democracies came to be seen as suffering from inherent deficit and inflation biases. The building blocks of the emerging paradigm were independent central banks, transparently and actively pursuing inflation control, and fiscal policy constrained either by policy rules or independent agencies of oversight that prevent political business cycles, policy surprises and pork-barrel politics. Since microeconomic incentives would work in a predictable policy environment, macro-prudential supervision of the financial system – in contrast to risk regulation of individual institutions -- was seen as largely superfluous (Brunnermeier et al 2009: 10).

The introduction of fiscal rules and independent central banks were novelties in Europe, closely related to the project of creating an Economic and Monetary Union (EMU), comprising an internal market among all EU members and a common currency for some. In the US, the 1980s also saw some institutional reform: a balanced budget rule for the federal government was introduced for the first time, the Federal Reserve Bank asserted its independence through money supply control and regulatory agencies for federal programmes were established. Some observers conceived this as regulatory state building, the emergence of a 'fourth branch of government' on both sides of the Atlantic, despite rather different political settings. Majone (1993, 1996) interpreted the EU as a regulatory state in the sense that the Commission acts legitimately as an independent trustee of national democracies, specifically to enhance the credibility of governments' commitment to open markets.

The commitment to price stability can now be recognized as part of this movement, ensured either by 'rules rather than discretion' (Kydland and Prescott 1977) or

Good Governance in Crisis or a Good Crisis for Governance?

delegation of monetary policy to independent central banks (Barro and Gordon 1983). Majone's interpretation draws on the US experience, although the regulatory state there has been the result of a power political struggle between the Presidency and Congress. Presidents successively gained control rights over the federal bureaucracy from the legislature and established a 'managerial presidency' (Pildes and Sunstein 1995: 11-15). The Fed's new emphasis on price stability under Chairman Volcker since 1979 was a separate institutional development but had a similar goal, namely to make economic norms of stability and efficiency trump considerations of political expediency. The different constitutional background gives us the comparative variation to assess how similar institutional innovations work in practice and under rather extreme circumstances. Three innovations and their actual working will be compared: agencies for fiscal oversight, fiscal rules and independent central banks.

2.1. Regulatory agencies for fiscal oversight

Delegation of policymaking authority to independent agencies became popular with the wave of deregulation and privatisation of public utilities in the 1980s and '90s (Pildes and Sunstein 1995: 3). These regulatory bodies, 'outside the line of hierarchical control or oversight by the departments of central government' (Majone 1996: 15), were seen as an alternative to public ownership or political control by ministerial bureaucracies. We can see the European Commission and the Office of Management and Budget (OMB) in this light, namely as regulators of budgets whose decisions can only be challenged by judicial review or, informally, by non-compliance.

All EU members are subject to fiscal surveillance, in the form of an annual cycle of peer review that assesses whether they comply with the major stipulations of the Stability and Growth Pact (SGP), such as having a deficit that does not normally exceed three per cent of GDP. The only difference between euro area members and other EU-members is that the latter cannot be fined under the Excessive Deficit

Procedure (EDP). The authority for EU fiscal surveillance is split between the self-regulatory ECOFIN Council, including the Eurogroup consisting of economic and finance ministers of the Euro area only, and the regulator in the guise of the Commission. Within the Commission, DG Ecfm (Directorate General of Economic and Financial Affairs) is responsible for fiscal governance and Eurostat for statistical governance. DG Ecfm is the more visible regulator of member states budgets, as it assesses member states' annual Stability and Convergence Programmes and prepares decisions for the Council. Eurostat is a legally more authoritative regulator of member states' fiscal accounting. Its rulings on how certain transactions affect the deficit or debt of general government, constitute secondary case law, are final and cannot be overruled by the Council (Savage 2005: 62; 192). If a member state refuses to comply by new accounting rules, Eurostat can decline certification of its reports which constitutes a breach of the Maastricht Treaty and can trigger an EDP – for which the cases of Portugal and France are precedents (Savage 2005: 149).

The powers of general inspection that DG Ecfm and Eurostat wield with respect to the budgets of EU member states exceed anything that the federal government in the US can exercise over the states (Sbragia 2004: 59). There is no US equivalent to the annual Convergence or Stability Programmes that ministries of finance in the EU have to submit annually. Fiscal oversight of states' use of funds is strictly tied to budgetary flows, i.e. the federal administration can attach strings only to transfer programmes by which it is funding states. While the EU does this as well, say for regional aid, this kind of control is more important in the US because federal grants cover a third of all state and local expenditure (Blöndal et al 2003: 52), amounting to about 3 per cent of US GDP. The strings attached to federal grants are controlled by the mighty appropriations committees of Congress and the powerful Office of Management and Budget (OMB). The director of OMB is a ministerial level position and a member of the President's Cabinet. For the budgetary process, this independent agency in the presidential administration assumes the policy-making functions that in most countries are assigned to the Treasury. In normal times, the US Treasury is concerned with the daily cash management of the federal government and plays a secondary role for policymaking, given that the Council of Economic

Good Governance in Crisis or a Good Crisis for Governance?

Advisors is also part of the Executive Office of the President (Blöndal et al 2003: 14, 47).

In budgeting, 'the President and the Congress "co-manage" the executive branch.' (Blöndal et al 2003: 39; cf Pildes and Sunstein 1995: 11-16) Once the budget is passed, the OMB monitors the compliance with rules at the programme and agency level. Congressional appropriations bills are more detailed and extensive than in any other OECD country, since Congress 'often dictates specific management decisions' (Blöndal et al 2003: 25). Hence, because fiscal transfers provide the entry point for oversight, the US federal government ends up regulating particular expenditures but not the fiscal envelope of the states.

The EU lacks controls over particular budget items, except if they raise specific issues of market integration. State aid rules are an important source of expenditure control. EU rules prescribe that both public procurement and subsidies to firms or sectors must observe strict non-discrimination between nationals and firms from other EU countries. These rules grant a number of exemptions (Art.87, s.2 and 3), e.g. for aid with 'a social character' to individuals, for promoting economic development or any objective that the Council has deemed worthy, as long as this aid is given on a non-discriminatory basis and does not affect trade unduly. While this is often portrayed as providing loopholes for continuing an inefficient practice, the Commission and the Court have achieved a remarkable streamlining of state aid policies in member states (Blauberger 2009). The 'state aid problem' is partitioned into one that is concerned with efficiency (safeguarding competition), subject to EU regulation, and another concerned with legitimate redistributive objectives, left to member states. This draws a line in the sand between economic and political objectives with which governments have learnt to live.

In the US, the oversight over state aid is left to courts. Ever since the 19th century, the Supreme Court has established the so-called 'Dormant Commerce Clause' in case law prohibiting discriminatory and protectionist regulation by a state in favour of the economic interests of its citizens (Redlich et al 2005: ch.5). This body of case law applies in areas that are not explicitly covered by the Commerce Clause which gives

the federal government the power to regulate all areas relevant to interstate commerce. But there is an important exception to this Dormant Commerce Clause: the 'market participant exception' says that a state may favour its own residents when it acts as a seller or buyer of goods and services, rather than as a market regulator. Regan (1986: 1193-1195) advances a rationale for this exception. Protection and discrimination seems to be allowed, first, whenever the state does not use traditional protectionist instruments, such as a tariff; and, second, when the intervention involves spending of the states' own funds. Spending is less coercive than regulation and taxation, and is inherently limited by the budget constraint. Case law has thus allowed states to buy only from local providers, waive taxes (i.e. forego revenue) on new manufacturers locating in the state and require firms to hire only local workers for state-funded building works. Thus, the use of state expenditures to support employment or bail out firms is less tightly regulated in the US than the EU.

2.2. Fiscal rules

Another way of dealing with a deficit bias of governments has been the instrument of numerical rules, complementing or substituting for independent agencies (Wyplosz 2005). Fiscal rules in the guise of balanced budget or Golden Rules are nothing new but the good governance literature has explained them in terms of their contribution to dynamic consistency and 'depoliticisation' of budgetary policy (Kopits and Symanski 1998; European Commission 2006: 129-132). To the extent that stabilization is necessary at all, it should be left to automatic stabilizers, notably income taxes and unemployment benefits, which make for a counter-cyclical variation of the budget balance and support credit-constrained households directly. Discretionary budgetary interventions are seen as prone to privileging some sectors, such as construction or public services, which distorts the allocation of resources beyond the recession (ECB 2009: 77-78).

The fiscal rules of the SGP require governments specifically to avoid an 'excessive' deficit already mentioned, avoid debt of more than sixty per cent of GDP and have a

Good Governance in Crisis or a Good Crisis for Governance?

budget 'close to balance or in surplus' over the business cycle. All rules are meant to avoid (a dynamic towards) high public debt since this would put pressure on monetary policy, as the Council conclusions establishing the SGP explicitly stated (Council 1996: para.18). The Pact was revised in 2005. Governments can now invoke exemptions from the deficit rule like systemic pension reforms or a sustained period of low – not, as previously, negative -- growth which allow postponement of steps towards being fined under the EDP.

Enforcement is a weakness of supranational and national rules in the EU alike.¹ Obviously, there is a debate on whether these rules are just 'smokescreens' (Debrun and Kumar 2007) and provide incentives for 'fiscal gimmickry' (Von Hagen and Wolf 2004). They are all self-imposed by sovereign actors, the ECOFIN Council in the EU, government agencies in member states (Wierdsma 2008: table 6.1, 256). But these slack enforcement mechanisms may not be an accident, given the absence of a stabilizing federal budget. The EU budget is not only small (about one per cent of EU GDP), it also has to be balanced annually. Thus even if it were bigger, the Community budget cannot vary with the business cycle. The sub-federal units (the member states) have effectively denied it a stabilizing role.

The use of fiscal rules is an apparent similarity between the EU and the US. Virtually all US states have balanced budget rules for a long time (NASBO 2008: table 11). They apply annually and relate to the operational budget only, i.e. to current revenue and expenditures. Capital outlays for multi-year public investments may be debt-financed but then debt or debt service limits apply (NASBO 2008: table 12). There is typically no spending without appropriation by state legislatures. But these rules were in place before the current onset of good governance. Only the fiscal rule at the federal level, the Gramm-Rudman-Hollings Act introduced in 1985, can be seen as an innovation inspired by 'depoliticizing' budget restraint. Yet, it did not achieve its aim of a federal balanced budget by 1991 and was replaced, first by the Budget Enforcement Act in 1990 and then the Balanced Budget Act in 1997. Since the federal

¹ For more detail see European Commission (2006: Part III). Reverse causation is a serious issue in these studies: governments may give themselves strong fiscal rules because they comply with budget constraints anyhow.

budget went into surplus since 1999, the constraints on new programmes were circumvented and the Act expired in 2002. All three Acts for a federal rule were parliamentary initiatives (Savage and Verdun 2007: 847-857).

How come that relatively good compliance with balanced budget rules has been found for many US states (Bohn and Inman 1996) while the Gramm-Rudman-Hollings Act failed to constrain the federal budget? The states' prudence is greatly facilitated by the opportunity of letting the federal government run the deficits when recession strikes. The federal government regularly grants disaster relief and temporary fiscal aid in times of economic downturns to states (GAO 2004). The budget stabilization funds that virtually all states maintain are often quite limited, for instance capped to not exceed 10 per cent of current revenue, and hence not able to smooth spending in a prolonged recession (NASBO 2008: table 19, 50). The uses that can be made of temporary fiscal aid are not prescribed. Aid is allocated on the basis of population size, not on the basis of fiscal need or capacity. Not only does this create windfall gains for some states, it also leads to moral hazard in that state governments do not build up sufficient rainy day funds of their own (GAO 2004: 5). The prudence of state budgets thus depends on a stabilizing federal budget which has been allowed to renege on complying with a balanced budget rule. This is the exact opposite of the EU where member states cannot rely on another tier to do the stabilization for them and therefore must be allowed to run deficits.

2.3. Independent central banks

Until 1989, only the US, Germany and Switzerland had legally independent central banks (Lastra 1996: 9). The Maastricht Treaty requires all member states to make their central banks independent and the ECB is the independent central bank par excellence. Art. 105 states that 'the primary objective' of the ECB is price stability; it 'shall support the other economic policies in the Community' only if this can be done 'without prejudice' to price stability. The ECB not only exercises monetary policy autonomously but also enjoys goal independence, specifying what exactly price

Good Governance in Crisis or a Good Crisis for Governance?

stability means (not more than two per cent inflation). The members of the Executive Board are appointed by the Council of Heads of State, after consultation of the European Parliament and the national central bank governors, and serve a non-renewable eight year term. The President explains ECB policy regularly to the Monetary Committee of the European Parliament, but these hearings are low key events where committee members ask polite questions.

National central banks are a buffer and an intermediary between the ECB and the fiscal authorities in each member state. The capital of the ECB is held solely by (all EU) national central banks included in the European System of Central Banks (ESCB). National central banks have to pay any net losses that the ECB incurs, e.g. in the pursuit of the lender of last resort function (Art. 33, s.2 and Art.29, s.1 ESCB Statute). That is, national taxpayers would have to pay in proportion to the paid-up capital share of their central bank. In turn, if national central banks bail out domestic financial institutions that have significant business in other member states, the ECB can compensate that central bank for the losses incurred out of its surplus from seignorage (Art. 32, s.4, ESCB Statute). This holds of course only as long as the ECB makes a profit, which may not be the case, for instance if the Euro revalues strongly causing losses on foreign exchange reserves. What needs stressing here is that there are redistribution mechanisms between member states that work through the 'burden-sharing' between the ECB and national central banks (Pauly 2010: fn 3). These are redistribution mechanisms that are beyond the reach of legislatures; neither the European Parliament nor national parliaments have a say in when or how they are used.

The very independence of the ECB stands in the way of giving it a decision-making role in financial supervision.² If it could directly engage in rescue operations for cross-border banks in the EU, say by buying shares of such a bank (recapitalisation) or buying bad assets from a bank, this could lead to large bills for Treasuries to foot.

² The Council (2009: par.19) has endorsed a recommendation in the de Larosière report (2009: 44) to introduce a European Systemic Risk Council for macro-prudential supervision, chaired by the ECB, although it would only be allowed to issue risk warnings to national authorities, not to financial institutions directly.

After all, the assets of or from the troubled bank have been doubtful, triggering a rescue operation in the first place, and may have to be written off at least in part. This can easily overstretch the ECB's earning capacity. Thus, national Treasuries would have to back up the ECB if it was responsible for systemic bank bailouts. This they are not likely to accept, given the ECB's independence from governments.

The Fed is 'independent within government'. That is, monetary policy decisions do not have to be ratified by other parts of the executive branch, yet the Federal Reserve System of 12 member banks 'is subject to oversight' by Congress and 'must work within the framework of the overall objectives of economic and financial policy established by the government' (Board 2005: 3). Congress watches this prerogative quite jealously. As one insider puts it, 'the most important national political figures for the Fed are the chairmen of the House and Senate committees that deal with banking and central banking. The President clearly is secondary in importance for the Fed' (Axilrod 2009: 8). These Committees can stage embarrassing public hearings and the Senate has to confirm the President's appointments for the governors of the Board, the Chairman and the Vice-Chairman. The Chairmen's four year terms of office can be renewed.

The Fed acts a buffer for its member banks while its backing comes in turn from the Treasury. In what was once considered to be an extremely unlikely event, namely that the Fed could become insolvent, the Treasury would bail it out (Buiter 2009). Letters of Treasury secretary Hank Paulson are posted on the Fed's website to give an assurance for the bailout operations since 2008.³ Unlike the ECB, the Fed has actual responsibilities in prudential supervision and regulation that it shares with a number of other agencies (Board 2005: ch.5). The Obama administration has tried to streamline this division or fragmentation of responsibilities in favour of a stronger role for the Fed but this attempt has enraged the critics of its crisis management even more (FT 2009a).

³ URL: http://www.federalreserve.gov/monetarypolicy/bst_reportsresources.htm

3. The response to the crisis in the EU and the US compared

The financial and economic crisis since 2007 is a stress test for any policy framework that wants to ensure 'economically sound', in contrast to politically expedient, macroeconomic stabilization. The indicators that the worst may be over remain ambiguous even two years into a crisis that started officially in August 2007 and reached its climax with the collapse of Lehman Brothers in September 2008. The interest here is to see to what extent the responses have observed the norms of good governance, specifically isolating stabilization from distributive politics in legislatures. The analysis is confined to the first wave of stimulus programmes. The most notable feature of responses to this crisis was a revival of fiscal activism, so I start with this.

3.1. Fiscal responses

In the beginning, the effectiveness of governments was measured in how big a stimulus package they could put together at short notice. The US won hands-down on this media account, an impression created by bank bailouts of truly astonishing proportions. However, they may do little for stimulating demand and employment. Bank bailouts served to maintain the solvency of banks but hardly managed to expand new credit to firms and households. Banks kept reserves and central bank credit on their balances or reduced more expensive debt vis-à-vis other creditors ('deleveraging'). And monetary tightening will set in as soon as credit expansion began to revive.

To start with discretionary fiscal interventions: The US federal government was first in passing bold measures under the outgoing Bush administration. It enacted a fiscal stimulus package in the first half of 2008 that consisted mainly of sending \$100 billion worth of tax rebates directly to households (Broda and Parker 2008). President

Obama signed the American Recovery and Reinvestment Act (ARRA) in mid-February 2009 authorizing the spending of \$787 billion over two years. The agency of fiscal oversight, the OMB, developed and monitored the standard terms and conditions for all grants and contracts; a board of inspectors general was entrusted with overseeing the disbursement of funds by federal agencies. A dedicated website has been set up that allows tracking the use of funds.⁴

The European Economic Recovery Plan (EERP), agreed in mid-December 2008, had a volume of €200 billion for 2009 (\$256 billion). The Plan added up and provided a common framework for what member states were spending to fight the crisis. The EU budget provides only a fraction of this sum, namely €30 billion. The Commission maintains a dedicated website that has a chronology of measures taken at member state level, that have to be scrutinised and approved by the Commission, mostly under the pretext of state aid rules but also under fiscal surveillance.⁵

At the time that the EERP was agreed, the projected shortfall in demand was considerably smaller than the estimates seven months later⁶ but these in turn appeared too pessimistic in autumn 2009. We can see in this uncertainty of macroeconomic data one of the reasons why governments may want to delegate policymaking authority to independent agencies. It is politically risky for majoritarian actors to take responsibility for data-driven decisions. Elected politicians are not supposed to be driven by data but by political values, yet in emergencies these values provide little guidance.

The estimated size of these fiscal stimulus packages are given in table 1, both what the IMF (break-down in annual figures and total, from March 2009) and the OECD (total, June 2009) have published, to account for the considerable uncertainty in the data.⁷ For reasons of clarity, only the biggest EU member states are listed, counting

⁴ At URL: www.recovery.gov

⁵ At URL: http://ec.europa.eu/economy_finance/focuson/focuson13254_en.htm

⁶ For instance, in November 2008 the OECD estimates of (negative) output gaps for 2009 and 2010 were only half of those they estimated in June 2009 for France, and only a third of the later estimates in Germany.

⁷ The OECD shows the stimulus as share of the 2008 GDP which tends to give lower figures, in particular for Continental Europe as these economies started to shrink in 2009 only. The OECD

Good Governance in Crisis or a Good Crisis for Governance?

for about 80 per cent of EU GDP. Neither figure of the total includes liquidity or recapitalisation measures for the financial sector because these ('below-the-line') budget operations have an uncertain and at best indirect effect on demand, as outlined above.

Table 1

Estimated contribution of discretionary fiscal measures 2008-2010 (% of GDP)

	2008	2009	2010	IMF Total	OECD Total
France	0.0	-0.7	-0.7	-1.4	-0.7
Germany	0.0	-1.5	-2.0	-3.5	-3.2
Italy	0.0	-0.2	-0.1	-0.3	0.0
Spain	-1.9	-2.3	n.a.	-4.2	-3.9
UK	-0.2	-1.4	-0.1	-1.5	-1.9
United States	-1.1	-2.0	-1.8	-4.9	-5.6

Source: IMF (2009: Table 4); OECD (2009: Table 1.7, as share of 2008 GDP)

Note: 'The figures have been corrected for: (i) "below-the-line" operations that do not impact the fiscal balance; and (ii) the fact that in some countries part of the announced stimulus included measures that were already planned for.' (IMF 2009: 13; similarly OECD 2009: 60)

What is noteworthy about the figures for Europe is the diversity of responses, contradicting the view that the fiscal framework imposes a one-size-fits-all policy. It also shows that rhetoric is typically the opposite of action: while the German government has been vocal about the need for fiscal restraint, it decided on one of the larger discretionary packages, while France and the UK, urging their European neighbours to go for large interventions, stimulated much less. The UK was hampered by fiscal overstretch due to massive bank bailouts while the discrepancy between rhetoric and action in the French position indicates a wait-and-see attitude which was alleged to mark the EU's response to the crisis (Krugman 2009). Observing Germany's hypocrisy and Spain's decisiveness suggests, however, that this does not apply across the board.

figure also takes no account of discretionary measures of US state which are overall pro-cyclical and thus reduce the effective stimulus shown (OECD 2009: 60, fn.5).

In the US, about half of the projected shortfalls of state budgets, to the tune of \$250 billion through 2011, are covered by \$135 billion federal grants and distributed on the basis of existing formulas (Scheppach 2009). These additional general funds⁸ primarily free up states' matching funds for Medicaid and education which can then be re-programmed. In particular the Medicaid formula guarantees that federal funds go to states that are hardest hit by unemployment in the course of which individuals lose occupational health care insurance. ARRA also devoted considerable resources to increase state spending on unemployment benefits raising compensation levels (by \$25 per week), eligibility (e.g. to part-time workers) and duration (up to 18 months instead of 6 months).⁹ This is against the background that by December 2008, thirty states were bound to run out of funds for their employer-financed unemployment insurance, two (Indiana and Michigan) had already become insolvent (Herald Tribune 2009). States are then forced to restrict access, raise contributions from employers or borrow from the federal government at a cost of 4.7 per cent interest if not repaid within the fiscal year. To avoid more pro-cyclical measures, the package of February 2009 created a new programme (Federal Additional Compensation) that offers interest-free loans to states until June 2010.

There are no systematic differences in the substance of stimulus measures between Europe and the US. As table 2 shows, all packages combine temporary expenditure increases with largely permanent revenue reduction. With the exception of Italy, all support infrastructure investment, social safety nets and environmentally-friendly technology, and all reduce personal income taxes. None aims directly to increase public employment. That is, we can discern a clear attempt to avoid lasting expenditure increases and a startling optimism that tax revenues can be cut permanently, but no big difference between advanced OECD countries.

⁸ In contrast to the remaining \$140 billion ARRA funds for states that go to specific programmes controlled by the federal government.

⁹ This is Title II of ARRA, the so-called 'Assistance for Unemployed Workers and Struggling Families Act'. For a summary see <http://www.naswa.org/recovery/>. Overall, the states receive \$275 billion of the total \$787 billion ARRA funds.

Table 2

Types of stimulus measures, 2008-2010 (as announced by 28 February 2009)

	FR	GE	IT	SP	UK	US
<i>Expenditure measures</i>						
Infrastructure investment	T	T		T	S	T
Support for SMEs		T				
Social safety nets	T	T	T	T	T	T
Housing/construction support	T	T		T	T	
Strategic industries support		T		T		
Public employment						
Other (green technology subsidies etc)	T	T		T	T	T
<i>Revenue measures</i>						
Corporate tax reduction/ depreciation	P	P/T				P
Personal income tax reduction	T	P		P	P	P
Indirect tax reduction (VAT etc)		P		S	S	
Other					P	

Source: IMF (2009: Table 5)

T: Temporary measures (with explicit sunset provisions or time-bound spending)

S: Self-reversing measures (costs of which will be recouped by compensatory measures in future years)

P: Permanent measures (with recurrent fiscal costs)

How much did automatic stabilizers contribute, i.e. revenue and expenditure items (such as income taxes or unemployment benefits) that make budget balances vary counter-cyclically with booms and recessions even if the government does not take any discretionary action? Table 3 gives the contribution of automatic stabilization, based on the latest OECD measures for budget elasticities which do not change much over time (Girouard and André 2005): a figure of 0.53 means that the budget balance declines by about half a per cent in response to a negative output gap of one per cent. The contribution of automatic stabilization is a result, first, of this strength with which budget items respond, and, second, the size of output gaps. A figure like -2.0 (estimate for France in 2009) means that the budget balance is projected to go into deficit in response to the cyclical downturn, adding about two per cent to aggregate demand.

Table 3

Estimated contribution of automatic stabilisation (as % of GDP)

	Overall budget responsiveness ^a	2008		2009		2010	
		OGap	AutStab	OGap	AutStab	OGap	AutStab
France	0.53	0.2	0.1	-4.1	-2.0	-4.9	-2.5
Germany	0.51	1.9	1.0	-5.4	-2.7	-5.7	-2.9
Italy	0.53	-0.9	-0.5	-6.5	-3.4	-5.8	-3.1
Spain	0.44	-0.9	-0.4	-6.5	-2.9	-8.2	-3.6
UK	0.45	0.4	0.2	-5.4	-2.4	-6.4	-2.9
USA	0.33	-0.5	-0.2	-4.9	-1.6	-5.4	-1.8

Source: Girouard and André (2005: table 9), OECD (2009: 71), own calculations

- a Sum of the elasticities for corporate, personal income and indirect taxes, social security contributions and for all current expenditure (mostly unemployment compensation).
 OGap Output Gap is the deviation of actual output from estimated potential output as % of potential GDP, published by the OECD in June 2009.
 AutStab Automatic Stabilisation, ie the estimated annual change of the budget balance as % of GDP; calculated by multiplying the measure of overall budget responsiveness by the annual output gap.

The second column of table 3 shows that budgets of European countries are about 25-40 per cent more responsive than in the United States. This is no surprise. *Ceteris paribus*, automatic stabilizers are more effective the larger the size of government, the more progressive the income tax system, and the larger the share of cyclically responsive budget items such as corporate taxes or unemployment benefits. On all these accounts, Europe's more generous welfare systems and more burdensome tax states are bound to be more effective than the US (Girouard and André 2005: 20-25). General government expenditure in the US is about thirty per cent of GDP, two thirds of which by the federal government (Blöndal et al 2003: 52), below the OECD average of over forty per cent. The stabilizing effect of the US federal budget is partly undone by the pro-cyclical effect of state and local fiscal policies (Follette et al. 2008). By contrast, the EU budget balance does not contribute anything; it is too small and does not vary with the business cycle.

Tables 1-3 suggest that the US and the EU are not that different as regards the policy output of overall fiscal stabilization and the concrete steps taken. Adding up the fiscal contribution to aggregate demand as calculated in tables 1 and 3 shows that the estimated US stimulus over three years (8.5 per cent of GDP) is not much higher than

Good Governance in Crisis or a Good Crisis for Governance?

the UK's (6.8 per cent), similar to Germany's (8.1 per cent), and lower than Spain's (11.1 per cent). Most of the differences are accounted for by differences in the evolving output gaps. This is contrary to what most commentators suggest. The impression was created because the US intervention was much more visible in bank bailouts and the drama of stimulus packaging played out in Congress. European countries relied more on automatic stabilizers or downplayed the extent of their discretionary intervention in the case of Germany.

Relying on automatic stabilization in the member states spared EU governments the political drama in the Council of having to agree on joined, yet tailored fiscal action for a heterogeneous union with diverse needs and capacities, in the spotlight of national media which would closely watch how the costs are shared. The reliance on automatic stabilizers can be justified on the same grounds as other good governance institutions although it usually is not (Mabbett and Schelkle 2007: 87-88). Thus, the different mix of discretionary and automatic measures in the fiscal stimulus of the US and the EU is evidence for the Europeans relying more on good governance institutions –not because they are inherently more attracted by these principles but because these institutions compensate to some extent for the unwillingness or inability to coordinate their policies in the absence of centralised fiscal authority.

3.2. Monetary responses

Both central banks, the ECB and the Fed, responded with an unprecedented injection of liquidity and adopted 'unorthodox measures', even though heterodoxy means something different for the two. The Fed brought down interest rates within 2008 by four per cent to a target policy rate of zero to 0.25 per cent. It first expanded the money supply by lending directly to banks and then through outright purchase of commercial papers, thus expanding bank reserves massively (Kuttner 2008: 2-5). This quantitative easing extended to the public sector from 2009 onwards. By monetizing public debt, the Fed replenished its holding of Treasury securities that were lent to the private sector in operations of qualitative easing, taking privately-issued

securities of less liquidity and higher insolvency risk as collateral. The Federal Reserve System also engaged in massive bailouts of individual institutions since March 2008: of Bear Stearns and of the American Insurance Group (through three Maiden Lane LLC facilities and additional lending to AIG), the latter being particularly noticeable as AIG is not a bank. The initial support for Citigroup and Bank of America was off-balance sheet and subsequently passed on to the Treasury.¹⁰ The bailout of individual institutions was a major driver of the Fed's budget expansion, as Maiden Lane I-III and the AIG facility accounted for almost 10% of the Fed's balance sheet at the end of 2008 when it had doubled in size (cf Kuttner 2008: 16). These rescue operations behind closed doors triggered a bipartisan motion in Congress (H.R.1207 and S.604), signed by over 300 representatives in the House and over 30 Senators, calling for a detailed audit of the Fed (FT 2009a; cf Hubbard et al 2009).

The ECB was keen not to expand bank reserves through asset purchases massively and raised the interest rate by 0.25 per cent as late as July 2008, against a backdrop of rising inflation to double its target rate. But it provided ample liquidity by lengthening the maturity of loans that banks could obtain, from twenty-eight days to three and six months, at a fixed rate and the entire amount they wanted. In normal times, banks get just a share of an overall given amount at a variable rate, depending on the bidding process of all banks. The ECB allowed for some innovation in liquidity management only, i.e. in lending to banks against collateral, not in asset purchases (ECB 2009: 32, 35; Bini-Smaghi 2009). Weber, the German member of the executive board, pointed out that the bank-based financial system of the Euro area does not require the same amount of creativity as a frozen capital market-based system (FT 2009b). That is to say, in order to pump liquidity into the economy the ECB could use the traditional channels of monetary policy, lending to banks, and did not deal in capital market instruments that blur the line to investment banking.¹¹

¹⁰ URL: http://www.federalreserve.gov/monetarypolicy/bst_supportspecific.htm

¹¹ Chancellor Merkel also made it quite clear that she would oppose anything more creative by the ECB when the bank announced one small asset purchase programme of covered bonds (FT 2009d). She thus engaged in a calculated break of the taboo that German governments do not comment monetary policy.

Good Governance in Crisis or a Good Crisis for Governance?

Between October 2008 and March 2009, the ECB brought down interest rates by 2.75 per cent to the minimum target rate of one per cent where it stayed. The one 'unorthodox measure' the ECB was ready to take was qualitative easing (ECB 2009: 103-104; 107-109). Assets became eligible collateral even if traded in non-regulated markets, or rated BBB-, indicating a high insolvency risk. Other unprecedented steps included the ECB lending five and ten billion Euro to the Hungarian and the Polish central banks, respectively, in fall 2008, thus supporting their commercial banks which consist largely of foreign subsidiaries and branches from Austria, Belgium, Germany, and Italy. The ECB also agreed to introduce swap lines under which central banks can automatically draw on currency facilities from each other; not only with the US Fed and the Swiss central bank which are obvious providers of world liquidity, but also with the Swedish central bank.¹² This happened in light of the rapidly deteriorating financial conditions in the Baltic states where Swedish banks are heavily engaged.

Rescue operations for individual banks are a matter for national authorities in Europe, even when cross-border banks are involved. A dramatic bailout was staged for the 'Euro bank' Fortis, noticeable not only because of its sheer size but also for the presence of the ECB President at the talks between three member states (Netherlands, Belgium and Luxembourg). It ended with a break-up of the bank in three national entities, each government taking a forty-nine per cent share in their country's Fortis, at a total cost of €11.2 billion (\$16.1 billion) (BBC 2008). Rival Dexia faltered on the Fortis news two days later; the world's biggest lender to local governments had to be thrown a lifeline by the French and Belgian governments, to the tune of €6.4 billion (\$9.2 billion) (Bloomberg 2008). In neither case was there any news about engagement of the ECB directly or indirectly through national central banks, although the Dutch and the Belgium central banks were involved.

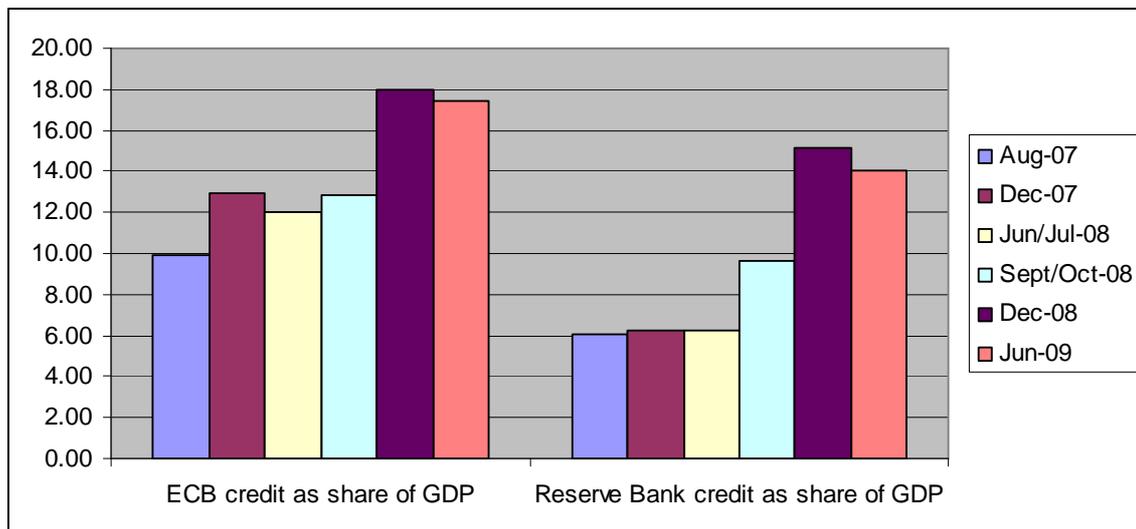
Despite considerable differences in how monetary crisis management was conducted, there are similarities in policy output, specifically in the contribution of central bank credit to the economy, measured relative to GDP and relative to bank

¹² Sweden is not a member of the Euro area.

credit (figures 1a and 1b). Given its capital market-based financial system, Federal Reserve credit started from a lower base as a share of GDP but then increased dramatically. The refinancing of banks was the same in relative terms in the US and in EMU until the Lehman collapse, but again rose more dramatically in the US after that. The comparison of the two measures of central bank credit to the economy also reveals that euro area bank credit did not shrink as much as US commercial bank credit; hence ECB credit as a share of GDP is still higher than in the US while it does not reach the same proportions relative to euro area bank credit.

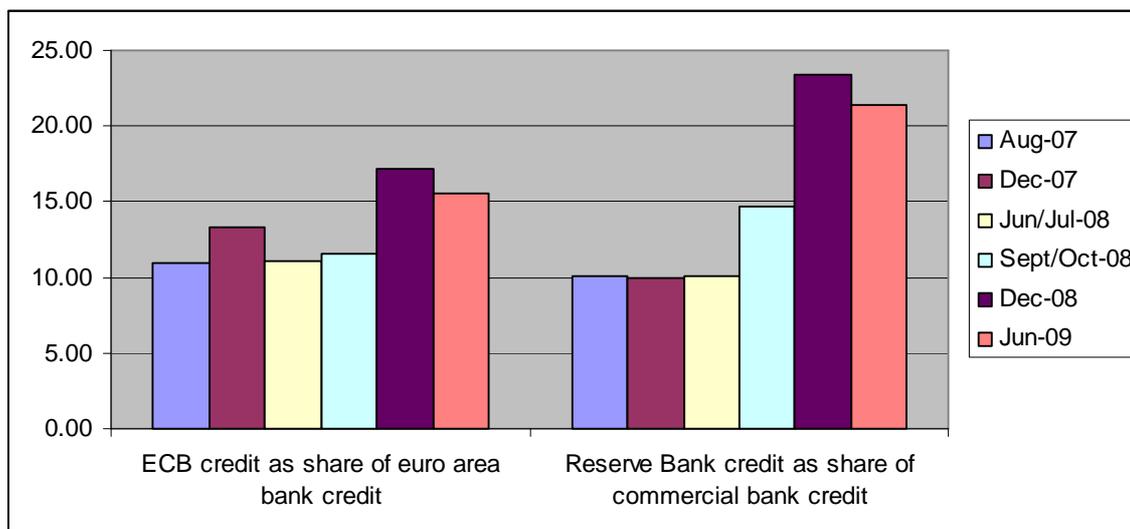
Graph 1a

Central bank credit as share of GDP



Graph 1b

Central bank credit relative to commercial bank credit



Sources: FRB and ECB for central bank and commercial bank credit, US Bureau of Economic Analysis and Eurostat for GDP figures

Note: ECB credit was calculated from the Consolidated financial statement of the Eurosystem as Total assets of the Eurosystem except Gold assets (item 1) and claims on non-euro area residents denominated in foreign currency (item 2).

The quality of assets has deteriorated in both banks' balance sheets although the default risk is considerably higher for the Fed. Moreover, the Fed holds now direct claims against the non-bank private sector, like a commercial bank, and Treasury bonds that it acquired in the direct monetization of public debt, like a dependent central bank. The ECB, by contrast, has refrained from either. Commercial banking can lead to large losses and even insolvency that would force the ECB to go cap in hand to the Council, leading to controversy about how to split the cost of a central bank bailout.¹³ Direct lending to Treasuries would raise issues of distribution: should the ECB lend to members with an unsustainable deficit because they need it most or to members whose public finances are least in need of a cheap source of Euro supply? The anticipated responses of financial markets would split the Council to breaking point. In sum, while presumably both the Fed and the ECB have an institutional self-interest in keeping their independent status, only the Fed has taken the risk in order to fight the crisis. The ECB would have to take into account that

¹³ This can be the motive behind the criticism of the ECB (and the Fed) that Chancellor Merkel chose to express publicly (FT 2009d).

such behaviour could call the very basis of the currency union into question, with no more common currency to manage after the dust has settled.

3.3. Regulatory responses

The role of regulatory oversight in fiscal crisis management is, at first sight, predictably different in the EU and the US. What is perhaps less predictable is that the Commission does not relent in its regulation of budgets while the federal government in the US, despite its huge fiscal leverage, exercises rather lenient oversight over the spending of its funds in the states.

The Commission keeps on recommending the opening of excessive deficit procedures, for instance as early as March 2009, against Euro area members which had structural – not cyclical -- deficits above three per cent of national GDP in 2008 already (France, Greece, Ireland, and Spain). The press statement¹⁴ stresses that member states ‘rightly adopted’ discretionary measures but that the SGP should be seen as a framework for an ‘exit strategy’ from rapidly increasing debt burdens. The Commission has reiterated this message continuously, so as to justify why the exemption clause -- no EDP against a country with low or negative growth rates – is not invoked instead. Recommending an EDP puts the issue on the agenda of the Ecofin Council. It must then come up with reasons why it is not following the recommendation of the Commission and the deficit country must outline a strategy to get back to normal.

The contrast with the US is stark. Against the backdrop of projected budget deficits in the two digits for 2009 and 2010, the Obama administration still puts its emphasis on the accountability to the current taxpayer rather than the burden on future taxpayers: ‘The President has made it clear that every taxpayer dollar spent on our economic recovery must be subject to unprecedented levels of transparency and

¹⁴ [JP/09/458](#)

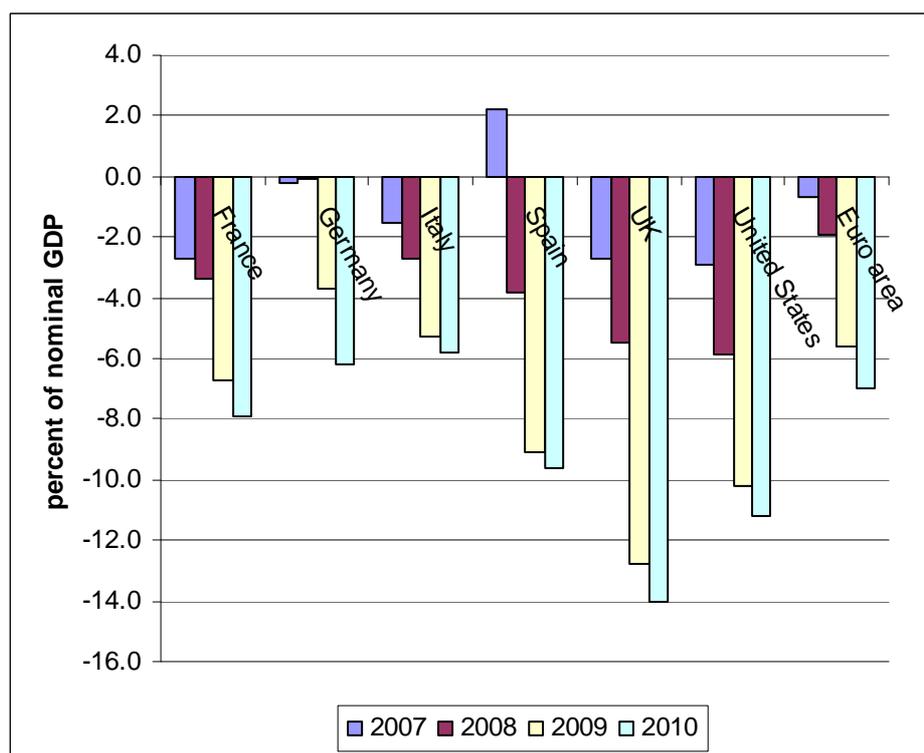
Good Governance in Crisis or a Good Crisis for Governance?

accountability'.¹⁵ To be sure, there is great unease among independent and conservative voters, from which the Republican opposition benefits, to the point where it jeopardizes health care reform. But the state finances are in such dire straits that there is little opposition raised by state legislatures.¹⁶

Figure 2 shows the evolution of budget deficits in the form of cash balances unadjusted for cyclical effects. This is how parliaments (and concerned voters) see budgets, namely including public resources that went into bank bailouts to prop up their reserves as well as the net spending triggered by automatic stabilizers, although it is not really an economically 'correct' view of the stimulus, which is shown by tables 1 and 3.

Graph 2

General government budget deficits 2007-2010



Source: OECD, June 2009; projections for 2009 and 2010

¹⁵At URL: <http://www.recovery.gov/?q=content/accountability-and-transparency>

¹⁶ See Fehr (2009) for an overview of the debate as of fall 2009.

In the EU, an immediate test for its regulatory role of preventing negative side-effects of national crisis management came in early October 2008. The Irish Parliament passed legislation to give a blanket guarantee for two years to all deposits and bonds held in six Irish banks, worth an estimated €400 billion. Greece followed suit for its national banks. The British, French and German authorities protested vehemently against these discriminatory measures. But a few days later Germany went on to guarantee savings in all banks operating in Germany. Although non-discriminatory, adopting such measures raised the spectre of competitive bidding for savings and a spread of banking crises all over Europe, particularly after British banks experienced a noticeable loss of deposits to Irish banks (Timesonline 2008). The Commission moved quickly and got, by mid-October, the agreement from the ECOFIN Council for an amended Directive on Deposit Guarantee Schemes¹⁷. It stipulates a minimum amount to be guaranteed (€100,000 at the end of 2009; possibly confined to 90 per cent of the deposit) and accelerated pay-out (within three days rather than three months). The difference to the budgetary solution in the US is telling: there the Federal Deposit Insurance Corporation provides a nation-wide guarantee which precludes a destabilizing competition for deposits. But the funds at its disposal have also made it attractive to divert the FDIC to the purpose of bank restructuring under the Geithner-Summers plan of March 2009, i.e. insuring bank shareholders directly while the normal task of deposit insurance is to insure savers only (Sachs 2009).

Another test case for regulatory oversight is the control of state aid. The EU's state aid rules were immediately challenged when governments in France, Spain, Britain, Italy, Germany and Sweden rushed to the rescue of their national car industries (EUobserver 2009). The French government triggered a storm of protest in Central Eastern Europe when it initially conditioned its €6.5 billion support for Renault and Peugeot on the stipulation of no plant closures in France for five years, which implied imminent plant closures in the Czech Republic instead. The French government withdrew the condition on 25 February. The Commission stepped in resolutely, presenting a Communication on guidelines for admissible support of the

¹⁷ The draft directive is available at:
http://ec.europa.eu/internal_market/bank/docs/guarantee/dgs_proposal_en.pdf.

Good Governance in Crisis or a Good Crisis for Governance?

car industry (EUobserver 2009).¹⁸ Subsidies to households for scrapping their old cars must not discriminate against any supplier, no matter whether it is foreign or a national brand. Aid should be limited to firms with liquidity problems that did not have well-known problems pre-dating the crisis, preferably through indirect measures that support consumer demand and make banks provide credit. But state aid rules regarding public guarantees or subsidised loans for the industry have been relaxed for a limited time of 2-3 years. The German government's rescue package for Opel from June 2009 is now testing these relaxed rules before the Commission. On 23 September, shortly before the German elections, the Commission raised concerns about possibly discriminatory protection of jobs in German plants reminding authorities that the Temporary Framework of relaxed state aid rules does not allow to give state aid conditional upon 'a specific business plan ... which defines the geographic distribution of restructuring measures' (European Commission 2009). The Commission was bolstered by the outrage that the Opel deal triggered in other member states, above all in Belgium, Spain and the UK.

In the US, the initial guidelines of the stimulus plan do not contain an explicit prohibition of states' discriminatory use of federal grants by the regulator, the OMB. There is no reference to 'protection' or to 'discrimination' with reference to states (OMB 2009: para.1.6). A House amendment to an energy and waters appropriations bill in summer 2009 stipulated that 'none of the funds made available in this Act may be used to purchase passenger motor vehicles other than those manufactured by Ford, GM and Chrysler'. It is unlikely to survive the vote in the Senate because it violates international trade law, but not because there are national rules that prohibit discrimination, for instance against car manufacturers in the Southern states of the US where foreign manufacturers are mainly located (FT 2009c: 5). In contrast to discrimination, however, it is not allowed for states to use ARRA to substitute for their own spending. The Inspector General of the Department of Education has raised the issue of an 'inappropriate use' of funds in over a dozen of states, that is

¹⁸ See URL:

http://ec.europa.eu/enterprise/automotive/pagesbackground/competitiveness/com_2009_010_4.pdf, annexes and other documents can be found at URL: <http://ec.europa.eu/enterprise/automotive/pagesbackground/competitiveness/index.htm>.

states cutting their own spending on public education and substituting federal funds. By October 2009, one state seems to have been blocked from accessing federal funds for cuts that went too deep, namely to levels below state spending in 2006 (NPR 2009; OIG 2009). In contrast to the EU, the frontline here is between states and federal government, not between states.

4. Conclusions: Good governance in crisis or a good crisis for governance?

The response of the Obama administration was bold and unorthodox, largely unrestrained by concerns for the Fed's independence and its balance sheet as an effective monetary authority¹⁹. The regulatory oversight of the normally quite powerful Office of Management and Budget has retreated to the background; the collective action problems of joint stabilization and negative spillovers from state action were overridden by the Treasury's takeover, providing ad hoc substitutes for the weak social safety nets and counterbalancing effectively the pro-cyclical fiscal policies in the states. European crisis management, by contrast, relied heavily on national safety nets and built-in stabilizers. There was a great variety of responses even among the five big member states. EU regulatory oversight could contain spillover from national actions, yet there was little joint stabilization effort. Devolved fiscal responses by Euro area members put the ECB into the role of the most decisive, visible policymaker at the EU level although it was considerably less 'creative' than its US counterpart.

To put it somewhat simplistically, good governance is in crisis in the US – even the compliance with fiscal rules in the states are problematic if they lead to discretionary expenditure cuts that override (the small) automatic stabilizers. In the EU, it was a good crisis for governance, at least until autumn 2009. Member states accepted the

¹⁹ Effectiveness requires that the bank's claims on the economy are of shorter maturity than those of other financial institutions or that it holds instruments like Treasury bonds that can be sold at fixed nominal value in secondary markets.

Good Governance in Crisis or a Good Crisis for Governance?

intervention of the Commission to avoid the worst in terms of discrimination and protection while the ECB was unusually alert and avoided bank runs or currency crises in its neighbourhood. Only the fiscal rules enshrined in the Stability Pact were broken, yet most economic commentators thought they were not broken enough and the Commission used them as an entry point for discussing exit strategies.

How can we explain that good governance institutions, which existed in both polities before the onset of the crisis and had a longer tradition in the US, fared so differently? And can we describe this outcome adequately in terms of politicisation of macroeconomic stabilization in the US and of successful depoliticisation in the EU? Or did the crisis show that good governance institutions are inadequate when they are needed most and that the EU clings to them just reveals how dysfunctional the framework for stabilization is?

What has happened in this crisis is that US fiscal authority became extremely concentrated. State administrations and legislatures allowed this to happen as it was the only way to square the circle of a collapse in revenues and balanced budget rules. They as well as the too-big-to-fail banks exploited the fact that the federal government's hands were forced by the unfolding events, driven, paradoxically, by it being the only actor with the enormous resources required to avoid disaster. The collapse of Lehman in September 2008 and its aftermath sent exactly this message. Hence, the states got all the 'flexibility inherent in the maintenance of effort requirements' (OIG 2009: 1) for getting the ARRA funds – which invited quite a few of them to freeride and substitute federal for state finances. From the point of view of governance, it is a paradox of the weakness of strength.

The federal fiscal authority even extended to the Fed which, for the time being, has become the right hand of the Treasury. The latter happened already under the Bush administration. The continuity in this trend is personified in Treasury Secretary Tim Geithner, who was before the head of the New York Federal Reserve Bank responsible for the first big bank bailouts. The trend indicates that there was an obstacle to bold crisis management, namely Congress, which the Fed could overcome

as the 'off-budget, off-balance-sheet and off-the-Congressional-radar-screen' (Buiter 2009) arm of the Treasury.

The role of Congress as an obstacle suggests that it is at best imprecise, at worst misleading, to describe the US response as a politicisation of stabilization. After all, the concentration of fiscal authority put all politics under the imperative of economic stabilization. The exact opposite to politicization, namely the economization of politics as we know it, would be an equally valid characterisation. What seems therefore a more plausible description is that the tsunami of this crisis wiped out the lines in the sand that good governance institutions try to draw between macroeconomic stabilization and distributive politics. It could do so because major forces, political at the state level and economic in the financial sector, decided not to erect many defences.

But why did good governance institutions prove to be so robust in the EU, against the odds of most observers predicting renationalisation and a general meltdown of Community institutions, with few exceptions (Pauly 2010)? To be sure, there was evidence of protectionism and a weakening of the Commission during the French Presidency in the first half of 2009. Domestic politics as usual was not suspended. But the pervasive and severe character of this crisis was a blessing in disguise for cooperation in that it concentrated governments' minds, made them concede that nationalism had to be reined in and appreciate the insurance inherent in a stable common currency. Members accepted shared sovereignty over emergency measures for the national economy, as long as they did not require any permanent institutional changes such as a joint fiscal policy or the ECB as a powerful financial supervisor. Good governance institutions in the EU are self-enforcing in a crisis. They are bad weather institutions preventing the worst when governments are under pressure from domestic majorities while compliance in normal times is always problematic.

In political economy terms, it is again enlightening to analyze the robustness of good governance institutions in the EU in terms of boundaries between economic stabilization and distributive politics rather than in terms of depoliticisation. Bailouts of the car industry remain salient. Indeed the obligation to respect state aid rules or

Good Governance in Crisis or a Good Crisis for Governance?

fiscal rules allows a national politician to play even more the political saviour of jobs and livelihoods, because they know that anything too costly for the public purse or offensive for economic diplomacy is unlikely to pass unchallenged by the Commission. This leaves governments the freedom to pick a fight with Community institutions or to take it as a pretext and back down while blaming 'Brussels'.

The boundaries as drawn, namely to assign political responsibility to the member states and economic rationality to the EU level, are inimical to and dysfunctional for joint stabilization efforts. But this is exactly why the boundaries are politically self-enforcing. The EU has not got the fiscal muscles to make this assignment work. More noticeable even is the dysfunctional assignment for the coordination of monetary and fiscal policies. The ECB, a unitary actor who is judge and jury on its own performance, is in the comfortable position of insisting on the economic imperative. This, in turn, puts the member state governments in the position of never getting it right, providing incentives to insist that they must deal with domestic political opposition – which they therefore tend to play up. But it helps to divert from virulent conflicts among member states. Hence, neither governments nor the ECB have any political interest to change this. And despite the reasonable criticisms of economists mentioned in the beginning, the perceived policy outcome was not so dismal as to change this basic constellation.

Hence, we may conclude that, as the dust settles, the US is likely to return to drawing the boundaries in line with good governance principles, in particular restore the independence of the Fed and make the states take responsibility for their social safety nets. In the EU, good governance institutions have proven their political value to governments throughout this crisis, especially since the lack of joined-up stabilization efforts has not hindered reasonably effective crisis management. Good governance institutions still have their political uses, even if they are not the embodiment of economic rationality that their proponents once thought.

References

- Axilrod, S.H. (2009) *Inside the Fed*, Cambridge, MA: MIT Press.
- Barro, R. and Gordon, D.B. (1983) 'A positive theory of monetary policy in a natural rate model', *Journal of Political Economy* 91: 589–610.
- BBC (2008) 'Deal agreed for Euro bank Fortis', 29 September 2008 [web document available at <http://news.bbc.co.uk/go/pr/fr/-/1/hi/business/761132.stm>]
- Bini-Smaghi, L. (2009) Letter to the editor of *La Repubblica*, translated in: *The Wall Street Journal*, 20 March 2009.
- Blanchard, O. (2009) 'L'Europe n'a pas réalisé l'ampleur du choc provoqué par la crise', Interview, [Les Echos, 25 March 2009](#) [web document, accessed 29 March 2009].
- Blauberger, M. (2009) 'Of "Good" and "Bad" Subsidies: European State Aid Control Through Soft and Hard Law', *West European Politics* 32: 719-737.
- Blöndal, J. R., Kraan, D.-J. and Ruffner, M. (2003) 'Budgeting in the United States', *OECD Journal on Budgeting* 3: 7-53.
- Bloomberg (2008) 'Belgium, France Lead EU6.4 Billion Rescue of Dexia', Update 3 published 30 September by F.Benedetti-Valentini and J.Martens.
- Board (2005) *The Federal Reserve System. Purposes & Functions*, 9th edition, Washington D.C.: The Board of Governors of the Federal Reserve System [web-document available at [fed.org](http://www.fed.org)].
- Bohn, H. and Inman, R.P. (1996) *Balanced Budget Rules and Public Deficits: Evidence from the U.S. States*, NBER Working Paper No. 5533, Cambridge, MA: NBER.
- Broda, C. and Parker, J.A. (2008) 'The impact of 2008 rebate', *VoxEU.org* contribution, 15 August 2008 [web document available at voxeu.org].
- Brunnermeier, M., Crockett, A., Goodhart, C., Persaud, A.D. and Shin, H.S. (2009) *The Fundamental Principles of Financial Regulation*, Geneva and London: International Center for Monetary and Banking Studies and Centre for Economic Policy Research.
- Buiter, W. (2009) 'What's left of central bank independence?' *Maverecon* blog 5 May 2009 [web document available at blogs.ft.com/maverecon].
- Council (1996) 'Report by the Council (ECOFIN) on the preparation for Stage 3 of EMU', Annex 1 of the Dublin Council Conclusions, 13-14 December.
- Debrun, X. and Kumar, M.S. (2007) 'Fiscal Rules, Fiscal Councils and All That: Commitment Devices, Signaling Tools or Smokescreens?' [paper](#) presented at the ninth Banca d'Italia workshop 'Fiscal Policy: Current Issues and Challenges' [web document available at [bancaditalia.it](http://www.bancaditalia.it)].
- De Grauwe, P. (2009) Government debt is both unsustainable and desirable, [CEPS commentary](#) 23 June 2009, Brussels: Centre for European Policy Studies [web document available at ceps.eu]
- ECB (2009) *Annual Report 2008*, Frankfurt a.M.: European Central Bank.
- Economist (2009) 'Financial reform in America: New foundations, walls intact', June 20th, pp.79-80.
- Eichengreen, B. and von Hagen, J. (1996) 'Fiscal Restrictions and Monetary Union: Rationales, Repercussions, Reforms', *Empirica* 23: 3-23.

Good Governance in Crisis or a Good Crisis for Governance?

EUobserver (2009) 'Brussels blames carmakers for auto industry crisis', [25 February 2009](#) [web document available at <http://euobserver.com>]

European Commission (2006) 'The Long-Term Sustainability of Public Finances in the European Union', [European Economy No.4](#),

European Commission (2009) 'State aid: Commission statement on aid for Opel Europe', [Memo /09/411](#), 23 September 2009, Brussels: European Commission.

Fehr, S. (2009) 'Weekly wrap: Calls increase to extend economic stimulus to help states', [9 October 2009](#) [web document available at stateline.org].

Follette, G., Kusko, A. & Lutz, B. (2008) 'State and Local Finances and the Macroeconomy: The High-Employment Budget and Fiscal Impetus', Finance and Economics Discussion Series (FEDS), Washington D.C.: Board of Governors of the Federal Reserve System.

FT (2009a) 'New monetary target', 8 October 2009, Financial Times [print edition], p.9.

FT (2009b) Transcript of FT interview with Axel Weber, president of the Bundesbank, 21 April 2009, Financial Times [web-document].

FT (2009c) 'US car plan irks trade partners', 4 August 2009, Financial Times [print edition], p.5.

FT (2009d) 'Merkel mauls central banks', 2 June 2009, Financial Times [web-document].

GAO (2004) Temporary State Fiscal Relief, Report to the Chairman, Committee on the Budget, United States Senate, 7 May 2004, GAO-04-736R, Washington D.C.: Government Accountability Office.

Girouard, N. and André, C. (2005) 'Measuring Cyclically-Adjusted Budget Balances for OECD Countries', Economics Department Working Papers No.434, Paris: OECD.

Herald Tribune (2008) 'States' Funds for Jobless are Drying Up', [15 December 2008](#), International Herald Tribune [web document].

Hubbard, G., Scott, H. and Thornton, J. (2009) 'The Fed's independence is at risk', 21 August, Financial Times [web document available at capmksreg.org].

IMF (2009) 'The State of Public Finances: Outlook and Medium-Term Policies after the 2008 Crisis, Working paper, Fiscal Affairs Department, Washington D.C.: International Monetary Fund.

Kopits, G. and Symanski, S. (1998) 'Fiscal Policy Rules', Occasional Paper No. 162, Washington, DC: International Monetary Fund.

Krugman, P.R. (2009) 'A Continent Adrift', [16 March 2009](#), New York Times [web document].

Kuttner, K.N. (2008) 'The Federal Reserve as Lender of Last Resort during the Panic of 2008', Working paper 30 December 2008, Committee on Capital Markets Regulation [web document available at capmksreg.org].

Kydland, F.E. and Prescott, E.C. (1977) 'Rules Rather than Discretion: The Inconsistency of Optimal Plans', *Journal of Political Economy* 85: 473-491.

Lastra, R.M. (1996) *Central Banking and Banking Regulation*, London: Financial Markets Group LSE.

Mabbett, D. and Schelkle, W. (2007) 'Bringing macroeconomics back into the political economy of reform: the Lisbon Agenda and the "fiscal philosophy" of EMU', *Journal of Common Market Studies* 45: 81-104.

Majone, G. (1993) 'The European Community: an independent "fourth branch of government"?', EUI working paper SPS no.93/9, Florence: European University Institute.

Majone, G. (1996) *Regulating Europe*, London and New York: Routledge.

NASBO (2008) *Budget Processes in the States*, National Association of State Budget Officers: Washington D.C. [web document available at nasbo.org].

NPR (2009) 'Report: School Stimulus Funds Not Used As Intended', National Public Radio broadcast, 11 October 2009 [[transcript](#) available on npr.org].

OECD (2009) *Economic Outlook*, June issue, Paris: OECD.

OIG (2009) 'Potential Consequences of the Maintenance of Effort Requirements under the ARRA State Fiscal Stabilization Fund', Alert Memorandum ED-OIG/L03J0011, 30 September 2009, Washington D.C.: US Department of Education, Office of the Inspector General.

OMB (2009) Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009', Memorandum for the Heads of Departments and Agencies from Peter R. Orszag, [M-09-10, 18 February 2009](#), Washington D.C.: Office of Management and Budget.

Pauly, L.W. (2010) 'The Old and the New Politics of International Financial Stability', forthcoming in: *Journal of Common Market Studies* 48, No.1.

Pildes, R. H. and Sunstein, C. R. (1995) 'Reinventing the Regulatory State', *The University of Chicago Law Review* 62: 1-129.

Redlich, N., Attanasio, J.B., Goldstein, J.K. (2005) *Understanding Constitutional Law*, 3rd edition, Albany NY: Matthew Bender.

Regan, D.H. (1986) 'The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause', *Michigan Law Review* 84 (May): 1091-1287.

Sachs, J. (2009) 'The Geithner-Summers Plan is Even Worse Than We Thought', [voxeu.org Comment](#), 7 April 2009 [web document available at voxeu.org]

Savage, J.D. (2005) *Making the EMU. The Politics of Budgetary Surveillance and the Enforcement of Maastricht*, Oxford: Oxford University Press.

Savage, J. D. and Verdun, A. (2007) 'Reforming Europe's stability and growth pact: Lessons from the American experience in macrobudgeting' *Review of International Political Economy* 14: 842-867.

Sbragia, A.M. (2004) 'Shaping a polity in an economic and monetary union: the EU in comparative perspective', in Martin, A. and G.Ross (eds) *Euros and Europeans. Monetary Integration and the European Model of Society*, Cambridge: Cambridge University Press.

Scheppach, R.C. (2009) 'The economy, the stimulus package and the states', top story [23 March 2009](#), stateline.org [web document available on stateline.org]

Timesonline (2008) 'Ireland extends deposit guarantee to foreign banks', [9 October 2008](#), Timesonline [web document available on business.timesonline.co.uk]

Good Governance in Crisis or a Good Crisis for Governance?

Von Hagen, J. and Wolff, G.B. (2004) 'What do Deficits Tell us about Debts? Empirical Evidence on Creative Accounting with Fiscal Rules in the EU', Discussion Paper No. 4759, London: Center for Economic Policy Research.

Wierds, P. (2008) Fiscal Rules and Fiscal Outcomes in EMU - Theory and Evidence, Reading: University of Reading, Department of Economics.

Wyplosz, C. (2005) 'Fiscal Policy: Institutions versus Rules', National Institute Economic Review: 191: 70-84.

Wyplosz, C. (2009) 'Transatlantic divergence in tackling the crisis', [voxeu.org comment](http://voxeu.org/comment), 17 March 2009 [web document available at voxeu.org].

Recent LEQS papers

- Schelkle**, Waltraud. 'Good governance in crisis or a good crisis for governance? A comparison of the EU and the US'. LEQS Paper No. 16, December 2009
- Keating**, Michael. 'Second Round Reform. Devolution and constitutional reform in the United Kingdom, Spain and Italy'. LEQS Paper No. 15, December 2009
- Hyman**, Richard. 'Trade Unions and 'Europe': Are the Members out of Step?'. LEQS Paper No. 14, November 2009
- Dani**, Marco. 'Economic and social conflicts, integration and constitutionalism in contemporary Europe'. LEQS Paper No. 13, November 2009
- Rodríguez-Pose**, Andrés & **Krøijer**, Anne. 'Fiscal Decentralization and Economic Growth in Central and Eastern Europe'. LEQS Paper No. 12, October 2009
- Cheshire**, Paul C. & **Magrini**, Stefano. 'Urban Growth Drivers and Spatial Inequalities: Europe - a Case with Geographically Sticky People. LEQS Paper No. 11, October 2009
- McCrea**, Ronan. 'The Recognition of Religion within the Constitutional and Political Order of the European Union'. LEQS Paper No. 10, September 2009
- Bertola**, Guiseppe & **Mola**, Lorenza. 'Services Provision and Temporary Mobility: Freedoms and Regulation in the EU' LEQS Paper No. 9, September 2009
- Walker**, Neil. 'Multilevel Constitutionalism: Looking Beyond the German Debate'. LEQS Paper No. 8, June 2009
- Frankel**, Jeffrey. 'The Estimated Trade Effects of the Euro: Why Are They Below Those From Historical Monetary Unions Among Smaller Countries?'. LEQS Paper No. 7, June 2009
- Colomer**, Josep M.. 'On Building the American and the European Empires'. LEQS Paper No. 6, June 2009
- Boeri**, Tito. 'Immigration to the Land of Redistribution'. LEQS Paper No. 5, June 2009
- Jones**, Erik. 'They Have No Idea... Decision-making and Policy Change in the Global Financial Crisis'. LEQS Paper No. 4, May 2009
- Frey**, Bruno. 'A New Concept of European Federalism'. LEQS Paper No. 3, May 2009
- Chalmers**, Damian. 'Gauging the Cumbersomeness of EU Law'. LEQS Paper No. 2, May 2009
- Bellamy**, Richard. 'The Liberty of the Post-Moderns? Market and Civic Freedom within the EU'. LEQS Paper No. 1, May 2009

LEQS
European Institute
London School of Economics
Houghton Street
WC2A 2AE London
Email: euoinst.LEQS@lse.ac.uk

<http://www2.lse.ac.uk/europeanInstitute/LEQS/Home.aspx>

