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My two-step solution to Europe's democratic and economic crisis

First stabilise financial markets by issuing eurobonds. Then abolish the European Union's stability and growth pact

Stefan Collignon for the Social Europe Journal, part of the Guardian Comment Network
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Greek taxi drivers on strike at a motorway toll near Athens to protest about the government's austerity programme. Photograph: Petros Giannakouris/AP

The financial crisis risks destroying half a century of European integration. It is primarily a political and not an economic crisis, and only a different political solution can solve it. The problem is the intergovernmental system of governance: member states' governments take decisions jointly, but each government pursues its own partial interests. Hence, political integration is the missing complement to an integrated economy. Intergovernmental policy decisions never represent more than the smallest common denominator, and the collective interests of all European citizens are neglected.

Witness the fiscal policy fraud of the Karamanlis government and how it has affected the euro. Witness Merkel's imposition of growth-killing austerity on the rest of Europe. Witness the financial panic after Berlusconi attempted to bribe the voters who are leaving him. In all these cases, and many others, the interests of ordinary citizens are violated under the cover of democracy. For national governments are, by definition, only concerned with the partial interests of their small national constituencies, where they seek to get elected on platforms that have usually little to do with Europe. However, European policies affect all European citizens. They are European public goods. How can citizens be said to "choose" when governments negotiate compromises to which they claim that "there is no alternative"?

The consequences of intergovernmentalism are a disaster. The decisions made by governments always come too late or do not go far enough. Financial markets panic because they cannot see who is in charge and what will be done. The crisis is schlepping from emergency to emergency. In the end, it is the government of the most powerful member state that dictates policies, even if there is no majority among citizens at the

European level. It is time that democrats in Europe, whether social or not, come to realise that this modern form of gerrymandering is neither efficient in managing our European public goods, nor democratic in any meaningful sense.

Democracy means that citizens can choose a government through universal suffrage and authorise policies that affect them. But this is what European citizens cannot do. Like kings in former times, Merkel and Sarkozy agree, the council decrees, and everyone is affected by their policies. Karamanlis or Berlusconi do what suits their re-election, but the damage is done for all. Giving more power to national parliaments over European issues is utterly counterproductive: it increases the number of veto players and makes efficient policies even less probable. National parliaments, in Helsinki or elsewhere, can block an agreement, but they have no power to choose the political direction of a European government. The only place where more power is democratically justified is in the European parliament.

The latest charade is the Sarkozy/Merkel proposal of putting the European council president Van Rompuy in charge of an "economic government". Leave aside that Merkel has immediately declared that this economic government is nothing else than the policy co-ordination of recent years, hence nothing new. Sarkozy's idea of making the European council of heads of states and governments responsible for economic co-operation is just as bad, as it neither ensures more efficient decision-making nor does it give citizens any democratic rights over choosing policies. The outcome is simple: it's austerity made in Berlin, stupid!

The alternative is a democratic economic government. A real government. A government controlled by citizens. Here is how a true economic government could solve Europe's crisis: First, the most urgent task is to stabilise financial markets and stop the speculation against certain member states, first of all Greece. There is a simple way to do this: issue eurobonds, ie financial securities that provide liquidity to member states, which otherwise have no more access to finance. There are different ideas how such eurobonds could be structured technically, but the purpose must be to ensure sufficient liquidity so that financial panic sales and bank runs are avoided.

However, it is also clear that one cannot leave this task to the European Central Bank alone, while governments push each other into insolvency. This would undermine the standing of the ECB and ultimately destroy its capacity to conduct monetary policy. In the end, sovereign debt is a matter of fiscal and not of monetary policy and this is why it must be controlled by the sovereign – ie citizens.

The second task is, therefore, to redefine the fiscal policy framework. If eurobonds are to provide liquidity to member states' governments, the issue of moral hazard needs to be addressed properly. Why would any government impose budget disciplines on its own electorate if it could count on getting all the money it wants from the European Union? A tough constraint is therefore needed. It is clear that the stability and growth pact is not able to fulfil this function. Poachers do not make reliable gamekeepers.

I therefore propose to abolish the SGP and to replace it by a new framework with the following features:

1. A European macroeconomic framework law is voted every year under the Lisbon treaty art. 294 on the ordinary legislative procedure, which determines what the appropriate aggregate fiscal deficit is for the euro area as a whole. This law takes into account the economic environment, growth and employment, the accumulated debt levels, and the world business cycle. The macroeconomic framework law replaces the rigid deficit limits of the SGP, which were never kept, and establishes a framework with greater (vertical) flexibility that an efficient macroeconomic policy in a single currency area requires.

2. The European commission then issues deficit permits against the authorised amount of the aggregate deficit.

3. These deficit permits are allocated to member states according to their GDP shares. Modifications according to the relative debt ratios (above or below 60%) are possible.

4. Deficit permits are transferable. If one member state needs to borrow more, it can obtain additional permits from other member states that do not use them. The transfer could be subject to deals between governments in the European council, or one could set up a market where deficits are traded like pollution permits. The transfer mechanism allows for the necessary horizontal flexibility that responds to asymmetric shock in member states.

5. A banking regulation that prohibits financial institutions from lending or helping raise euros for public authorities unless the borrower can present the equivalent amount of deficit permits. In other words, member states' capacity to issue debt is controlled at source; no need for complicated bureaucratic surveillance and punishment mechanisms.

The new fiscal policy framework of European deficit permits combines fiscal discipline (through the bank lending link to permits) with the need to allow more vertical and horizontal flexibility to respond to economic shocks and crises.

The proposed alternative to the SGP would become a policy tool for a genuine economic government for the euro area. By setting the overall deficit limit through the ordinary legislative procedure, which involves commission, council and the European parliament, the representatives of European citizens are empowered to make real choices that reflect the democratic preferences of their voters. Political parties can present alternatives; citizens can choose the party that seems to reflect their preferences best. Fiscal discipline is automatically implemented.

All it needs is political will.

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