The Euro and Political Credibility in Germany

Klaus Zimmermann and Tobias Just

The authors contend that the costs of the euro in Germany outweigh the benefits. How they determine this is interesting and controversial. But this point of view deserves a hearing.

CREDIBILITY is a scarce resource. If Francis Fukuyama (1995) is right in saying that a nation's welfare depends upon a significant level of trust and mutual credibility, then any government would be well advised to be trustworthy in the eyes of its voters. But mutual trust seems to be eroding continuously. In Germany, this process is reflected in the 1997–1998 debate over whether a referendum should be held on the introduction of the common European currency, the euro. All parties of the political center have rejected the proposal of a referendum, knowing well that the majority of German voters would have defeated the introduction of the euro. This anticipated outcome is quite interesting in view of the fact that the large German parties, in unusual unanimity, had repeatedly proclaimed the euro's distinct economic advantage. In the eyes of the voters, however, this reassurance by the politicians was not credible: At the peak of the debate, 71 percent of German voters

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did not favor the euro (ZDF-Politbarometer 1998), meaning essentially that most Germans were convinced that the costs of introducing the euro would outstrip its benefits—or that the benefits would be distributed extremely asymmetrically and the possibility of any counterbalance by means of redistribution would be low.[1] The discussion about the possibilities and implications of a referendum in Germany are therefore still legitimate, especially as the introduction of the euro was rejected in a recent referendum in Denmark (September 28, 2000), and a similar ending is to be expected in the United Kingdom.

Because of their bad experience with unstable money in the twentieth century, Germans are fearful about the potential for inflation with the introduction of the euro. However, the inflation rate in the euro region has remained remarkably low during the first two years after its introduction. In 1999, the Harmonized Index of Consumer Prices (HICP) rose at an average rate of only 1.2 percent (European Central Bank [ECB] 2000). Although the European inflation rate doubled in 2000, this increase could hardly be attributed to a misspecification of the new European monetary institution, as the acceleration of prices was mainly caused by the sharp increase in energy prices (ECB 2001).

While the internal value of the new currency gave a remarkably stable performance, the external value of the euro against the major foreign currencies did not prove to be stable. In 1999, for example, the euro depreciated by 14 percent against the U.S. dollar and by 24 percent against the Japanese yen (ECB 2000, 32–35). This trend continued through 2000 until December, when the euro rebounded against all major currencies. Figure 1 illustrates the two-year downward trend of the European currency

Usually, this depreciation trend is explained by the persistence of the different growth performances between the euro countries and the other industrialized economies, especially the United States. Hence, the depreciation of the euro should be due

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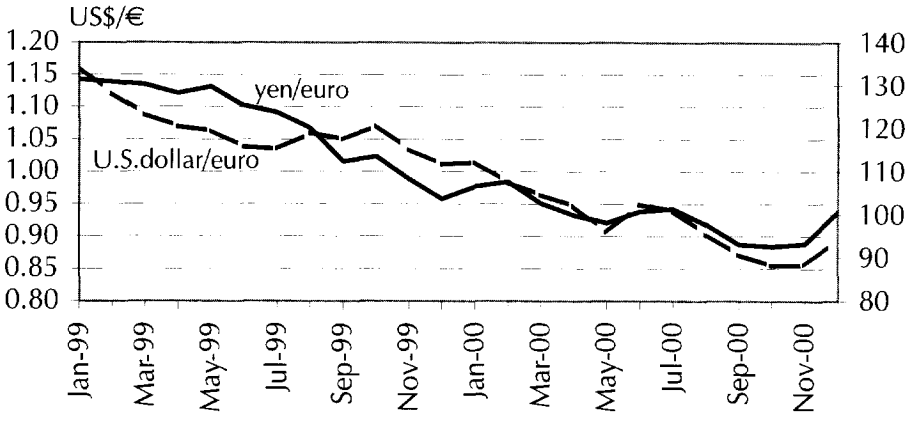

Figure 1. The Rally of the Euro

Source: ECB (2001).

to economic policies (labor-market rigidities, regulation in goods markets) rather than the newly created currency.

Critics, however, point out that financial markets still react quite sensitively to policy changes of the European Central Bank (ECB), which implies that the central bank still lacks a reputation for being stability oriented. This became evident during an intense discussion about a possible paradigm shift of the ECB in April 1999 after a modest reduction of interest rates on April 8, 1999 (Deutsche Bank Research 1999, 5).

The fact that, although the European currency is relatively stable internally, the Germans still oppose its introduction poses a question: Does the electorate possess the capacity to assess the new currency properly, or is the inflation performance simply an inadequate indicator of the currency's future development? Two interpretations are possible: Assuming the voters possess full information, the discrepancy between the ex ante assessments of the German politicians and their electorate may imply that possible benefits of the monetary union are asymmetrically distributed and redistribution had not been expected. But, if one

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assumes imperfect information, that is, that citizens err systematically with regard to the cost-benefit ratio of the monetary union, it might be concluded that the German political system, represented by its parties, suffers from a severe defect in communication and trust, as its electorate persistently opposes its politicians' suggestions.

In this article, we first give a brief overview of the debate over the costs and benefits of the European Monetary Union and, second, with the help of a general referendum model, we draw some conclusions about the perceived distribution of economic costs and benefits resulting from the introduction of the euro. We will demonstrate that the stated preference of the "euro winners"—a clear minority benefiting most from its introduction—not to allow a referendum to take place implies a perceived cost-benefit ratio of the euro higher than 1. From the German perspective, it would have been better not to introduce the euro for reasons of economic efficiency, at least not at this time and in this way.

The Political-Economic Background of the Euro

The Costs and Benefits of the European Monetary Union

It is an obvious fact that a monetary union should be implemented only if it is to be expected that the benefits will outweigh the costs. But it is no trivial matter to operationalize these variables and estimate their order of magnitude, as becomes evident from the heated debate, especially in Germany, on the economic and political scene.[2]

Proponents of the euro appeal to the reduced transaction and information costs, which, especially in open economies, can be considerable. Furthermore, the elimination of exchange-rate fluctuation, it is said, would have positive effects on foreign trade and international capital flows since one fundamental element of uncertainty (and hence the necessity to reduce risk via "hedge

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transactions") would be eliminated. An increase in the international division of labor is welcome, of course, as it indicates that factors were inefficiently employed previously. Finally, politicians in particular stress that, according to the "locomotive theory," monetary integration would be a decisive step toward fundamental political integration, tying nations closer together and making them less susceptible to inner-European political crises.

Skeptics, on the other hand, argue that especially the political benefits are hardly quantifiable. Further, differences in national interests (and not only within the European bodies newly formed for drawing up monetary policy) could lead to new economic problems and tensions in foreign policy (Feldstein 1997a). In addition, opponents regularly argue that the euro region is not an optimal currency area. According to Robert Mundell's theory (1961), a region is called an optimal currency area if a high degree of factor mobility and a homogenous production structure prevail within the region.[3] Thus, three things are decisive for assessing the costs of a currency union: the extent of factor mobility, the degree of specialization of the participating states, and the probability and size of asymmetric shocks.

There is little dissent in the scientific community that the sectoral specialization in Europe is lower than that in the United States, for example (Belke 1999). On the other hand, the international and interregional mobility of labor is significantly lower than in the United States (Peladigis 1996). As for the probability of asymmetric shocks and their relevance for the extent of involuntary unemployment, there still is a lot of disagreement among economists (Funke 1997; Belke 1999). So the question of whether Europe as a whole is an optimal currency area remains open. However, most authors agree that for a narrowly defined core union, the costs of a currency union will not exceed those of the "U.S.-American currency union" (Bayoumi and Eichengreen 1993; Neumann and von Hagen 1994; Erkel-Rousse and Mélitz 1995). A

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larger union with the neglect of the exchange-rate mechanism and the equalization of interest rates would then command alternative adjustment instruments such as less rigid labor markets or the consideration of transfer payments. As relatively rigid labor markets predominate in Europe and fiscal adjustments are (so far) not considered, some authors expect an increase in *cyclical unemployment* (Feldstein 1997b). Additionally, it is argued that a far-reaching harmonization of economic and social policies prevents system competition for better solutions. This might lead to a conservation of the high level of *structural unemployment.*

In trying to balance all these plausible deliberations and possible developments, one is confronted with significant problems, especially in the case of the political costs and benefits that are characterized by a high degree of uncertainty. Thus, when Martin Feldstein (1997b, 25) concludes that "the net economic effect of the European Monetary Union would be negative," this conclusion must initially be considered a subjective evaluation of the cost components mentioned above and not some inevitable fate. Our considerations do not claim to eliminate this uncertainty; rather, we try to derive some conclusions for the *expected* cost-benefit distribution, based on a positive analysis of stated preferences by citizens and politicians as an approximation of the actual costs and benefits or, at least, as an indicator of the credibility of political statements.

Winners and Proponents of Monetary Union in Germany

The obvious winners of the monetary union are companies with a high rate of export or extensive international ties, for the simple reason that the risk associated with exchange-rate fluctuation is eliminated. Banks and insurance companies are also on the winning side. Their opportunities for international expansion improve because of reduced transaction costs. Of course, depending

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on the incidence of these cost reductions, the large group of consumers *may* be winning, too.

In terms of the interests of politicians and political parties, leftist European governments that were biased toward inflation in the past will probably continue to be so. Therefore, Social Democrats might be interested in reducing the power of the stability-oriented central bank. This idea is in line with Douglas Hibbs's partisan theory (1977) and Alberto Alesina's rational partisan theory (1989). The latter especially has been confirmed by ample empirical evidence (Alesina et al. 1997). Yet Torsten Persson and Lars Svensson (1989) have argued that conservative parties may also have an inflation bias and pursue expansive fiscal policy, mainly via increasing the public debt as an election tactic to narrow the scope of action for a new government, should the opposition win. Or they do so in order to increase their own chances of returning to office.

This theory is especially true for Germany, where the pre-election polls of 1990 and 1994 did not indicate a victory of the incumbent Christian Democrats. And it is, of course, in line with the argument of Bruno Frey and Friedrich Schneider (1978) that conservative parties will only pursue low inflation policies as long as their survey results are good enough. However, it remains a historic fact that, in Germany, ex-chancellor Helmut Kohl's Christian Democratic Union (CDU), at least pro forma a conservative party and responsible for the largest expansion of public debt since World War II, was the driving force behind monetary union but strictly against holding a referendum to decide the issue.

What does this brief analysis of interests show? From Mancur Olson's (1965) perspective, one could identify a relatively small, homogeneous economic-interest group with a high capacity for self-organization and strong economic and political power having a profound interest in giving up national sovereignty in monetary and exchange-rate policy. At the same time, the leading political actors have a strong interest in pursuing monetary union

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because, in the age of globalization, it would seem to offer a greater possibility to regain room for the political maneuvering that has been lost on the national level. These claims are tested on the basis of a constitutional model in the following section.

Constitutional Aspects of the Introduction of the Euro

The euro is on the scene—that is a fact. From the perspective of the German citizens and voters, this means that the politicians have acted decidedly against the will of the German people. The introduction of the euro and the founding of the European Central Bank mean, ultimately, the abolition of the deutsche mark and an end to the autonomy enjoyed by the German Central Bank (Deutsche Bundesbank) in monetary policy. Nevertheless, in the eyes of its citizens, both these institutions have always been constitutive parts of the Federal Republic of Germany itself. The founding fathers of the German constitution did provide a perpetual guarantee for the principle of the welfare state (Article 20, GG)[4] but not for the elements of its monetary structure. However, in terms of constitutional reality as perceived by German citizens, it appears that with the abolition of the deutsche mark and declining influence of the Bundesbank, a vital component of national self-esteem and fundamental institutions guaranteeing freedom and democracy in Germany are being sacrificed. Moreover, from a strictly democratic perspective, it is irrelevant whether these institutions have constitutional status or even a perpetual guarantee: What is important is what the citizens *perceive* as the constitutive institutions of their society. If, however, it is the deutsche mark that has served to prop up the Germans' shattered historical self-image, then it would have been worth contemplating granting all citizens greater participatory power in deciding the fate of such fundamental institutions of the Federal Republic—that is, to hold a referendum.

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The Possibilities of Referenda as Provided by German Constitutional Law

None of the five established political parties demanded a referendum.[5] The politicians would have had to fear the popular vote, since it was highly unlikely that survey research and referendum results would have been incongruent. But, as luck has had it for the German politicians, the constitution approves referenda only under extremely restrictive conditions, a fact the German political class always tries to justify with the negative experiences during the Weimar Republic. Article 29 of the Grundgesetz regulating territorial changes of the German laender is the only provision in the constitution regulating plebiscitary forms of democracy.

Since it must be the genuine task of the political class to maintain democratic stability through good and widely accepted performance, it must be surmised that a referendum surely would have been possible, at least in principle.[6] This view is also shared abroad: "Germans are wondering why the Constitution cannot be changed to allow them a referendum. Many are denouncing the arrogance of a political class that is pushing ahead with something so fundamental despite the clear opposition of a large majority" (*The Times*, February 20, 1998). In case of doubt, a constitutional amendment would have been sufficient, as evidenced by the noiseless manner in which one is passed whenever parliamentary allowances are at stake. Therefore, the ruling political class rejecting any constitutional amendment in connection with the euro demands further analysis.

Referenda and the Information Problem

A central aspect of economic analysis is the "normative imperative" of consumer sovereignty. In democratic collective decisions, this is usually expressed in elections and performed according to

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majority rules. Then, it could be argued that, in case of information asymmetries prevailing, the electorate's revealed preferences do not match their real, hidden preferences. According to Richard Musgrave's concept of merit wants (1959), a putatively better informed governmental agent has the efficiency-enhancing duty to correct his principals' revealed preferences *ex post*. Actually, Bernd Hayo (1999) can show on the basis of Eurobarometer survey data that the better-informed Germans (those with a higher graduation) tend to propose the introduction of the euro.[7]

However, these empirical results must not mean a rejection of the referendum strategy. First, it cannot be ruled out that there is a direct connection between the educational level, that is, the level of information, and the question of whether one is a winner or loser of the project. Perhaps the euro introduction has a severe regressive effect: The educated are, on average, the winners. Second, to reject the referendum alternative, it must be ensured that the governmental agents are, per se, better informed. Of course, this must not be true. Paul Krugman (1994, 192), for example, summarizes his analysis of the European convergence criteria that were passed by the putatively better-informed political elite as follows: "If there is a lesson here, it is that serious and dignified men and women in impressive international meetings may have absolutely no idea what they are talking about." Gebhard Kirchgässner et al. (1999) even claim that an average German representative is not so well informed as the average Swiss citizen in a referendum.

At any rate, the implication of Hayo's findings can only be that, in the case of systematically distorted information, an efficient decision can result from an increase in information, and this actually is Hayo's political advice. He simply urges strengthening the information process within the electorate.

Furthermore, it is worth emphasizing that Bruno Frey and Gebhard Kirchgässner (1993) and Iris Bohnet and Bruno Frey

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(1994) conclude that citizens, on average, are better informed in referendum decisions than in parliamentary decisions. This conclusion stems from a higher intensity of discussion prior to the referendum, and it has an important implication for the euro referendum. If the majority of the people would reject the euro only because of a lack of information, proponents could advocate the referendum alternative in order to educate the winning majority.

A massive correction of the electorate's revealed preferences by the political class incurs another severe problem: It may lead to the population's erosion of trust in their representatives (Pharr and Putnam 2000) and in the political system (Cusack 1999). Not astonishingly, Germany ranks very low in an analysis of people's confidence in government carried out by Stephan Knack and Philip Keefer (1997) for twenty-eight market economies. Germany ranks twenty-second, behind even Brazil and Turkey.

Referendum Economics: The Cost-Benefit Ratio of the Euro

Proceeding with our discussion of constitutional issues, we now ask within an explicit cost-benefit context why a referendum was rejected so vehemently by the political class. We differentiate between winners (the minority) and losers (the majority).

In general, the euro should only be introduced if it would be efficient, in other words, only if the aggregate benefits would outweigh the aggregate costs:

- If costs (C) and benefits (B) were distributed equally among winners and losers, it is hardly conceivable why the winners fought so hard against a referendum. Under these conditions, the euro would be acceptable to all voters just because $B > C$.[8]

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- Even if the costs of introducing the euro were exclusively borne by the 71 percent majority of potential losers (the opponents), and all the benefits would exclusively accrue, in turn, to the 29 percent potential winners (the proponents), the euro winners could always compensate the losers and still keep enough for themselves because B > C. In this case as well, the winners need not fear a referendum—unless they wanted *all* the benefits for themselves, or if their promise to share the benefits was not credible in the eyes of the losers.

In both cases, therefore, it is hard to understand why the winners would have obstructed a referendum by any means unless, in fact, they indeed intended to lay an exclusive claim to euro benefits.

For the opposite scenario, where the economic costs exceed the benefits, we distinguish between two cases analogous to those presented above. If benefits and costs are equally distributed, everybody loses. Again, if this is the case, it will remain unclear why a referendum would have been rejected since the outcome will be the rejection of a euro that will be disadvantageous for everyone. If, however, the benefits are concentrated exclusively among the winners, and the costs, in turn, are borne exclusively by the losers, the picture will be decidedly different: If the winners' quota is given as WQ and the required majority is given as RM, then the costs for the losers per percentage point will be C / (100 – WQ). A referendum could thus always be won as long as the winners were able to convince at least some of the losers to vote yes by compensating them for their losses. Those who receive compensation are represented formally as the difference between the required majority and the winners' quota, namely RM – WQ. For example, if the required majority is 50 percent and the winners' quota is 29 percent, then at least 21 percent of the losers will have to be

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compensated in the amount of C / (RM – WQ) in order to make them vote "yes" in a referendum.

How many votes the winners would be able to "buy" depends, of course, on the cost-benefit ratio. At the same time, this ratio determines the maximum required majority necessary for the winners to tolerate, for example, 25 percent, 50 percent (simple majority), or 66.7 percent (qualified majority). The general formula identifying the limit beyond which a referendum could *not* be won is:

$$B < C\frac{RM - WQ}{100 - WQ} \quad \text{or} \quad \frac{100 - WQ}{RM - WQ} < \frac{C}{B}. \tag{1}$$

Only if the required compensation outweighs the benefits can a referendum not be won and therefore should not be initiated. For example, if the required majority (RM) is 66.7 percent and the winners' quota (WQ) is 29 percent, then the cost-benefit ratio must not exceed 1.88.

If we follow the argument assuming that not initiating a referendum reflects the preferences of the winning group and, consequently, the presumed cost-benefit ratio, then the figures given in the example above should be interpreted this way: A referendum would not be held because the costs would be at least 1.88 times the benefits in case of a two-thirds majority, which usually applies to constitution amendments. Logically, the cost-benefit ratio (when C > B) is a decreasing function of the required majority.[9]

If B < C (that is, if the euro is economically inefficient) and the gains and losses concentrated on the respective groups represent the real reasons that a referendum was rejected politically, then the fact seems to be a complementary confirmation of our hypothesis that, in political arguments, the "political" benefits for Europe are strongly emphasized. Ex-chancellor Helmut Kohl went so far as to declare that monetary union in general, and the euro in particular, would make future wars in Europe impos-

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sible (Feldstein 1997b, 25). This statement implies that, while the citizens may be able to assess their economic benefits on the one hand, they do not have the political foresight and astuteness, on the other, to calculate the additional "political" benefits accruing, for instance, from the reduced risk of conflict or even war. In general, then, for such "grand efficiency," the sum of economic benefits (B_{eco})—which the electorate can assess—and political benefits (B_{pol})—which the voters do not take into account—should be greater than the economic costs (C_{eco}).

In order to make a heretofore economically inefficient project acceptable to the citizens, they must be convinced that their political gains are big enough to counterbalance the potential costs. Only with this credible assurance could a referendum be held successfully. From equation (1) above, we can now conclude:

$$B_{pol} < C_{eco} \frac{100 - RM}{RM - WQ}. \qquad (2)$$

This is a simple difference calculation determining the amount of political benefits necessary to make an inefficient economic relation grand-efficient so that a referendum could be won. However, it is hardly possible to operationalize the political benefits of the euro, let alone quantify them. Ultimately this means: Anything goes![10] Using the political benefits argument, then, the euro is both *ex ante* and, under fortunate political circumstances, *ex post* justifiable, even if it is economically inefficient. Thus, the political class (and the euro winners) protect themselves—at least for the time being—against any discussion or criticism, which it tried to block as far as possible, and it becomes ultimately clear why a referendum could not have been admitted under any circumstances:

- The economic benefits in a narrow sense are probably lower than the costs—and the electorate recognizes precisely this.
- The political benefits are extremely unsure and quantitatively arbitrary. This is why they are not honored by the electorate.

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- The political benefits actually may be "high enough," but they are still not accepted by the voter. So even under this most advantageous scenario of the monetary union, the voters do not believe what the politicians tell them. This outcome implies that there are fundamental and empirically confirmed problems within the democratic system in Germany as stated above.

Conclusions

As we have seen, a bad, though altogether conceivable, scenario of euro effects can be plotted. We have also seen that a majority of the political class favor the euro, despite the risks, and that they are, in turn, supported by powerful groups (small, homogeneous, and very capable of self-organization) of winners in the business world.

Moreover, we have shown that this minority of euro proponents would, in fact, have to fear a referendum in only two cases, that is, where the outcome of the referendum would be adverse to their interest. In principle, a referendum is always disadvantageous when the benefits accrue exclusively to the euro winners and the costs, respectively, accrue exclusively to the losers, and (a) when the benefits from introducing the euro exceed its costs and the winners claim all of them for themselves, or (b) when costs exceed benefits to a significant degree. The latter case, when $B < C$ along with the euro proponents' preference not to admit a referendum regardless of the size of the required majority, has allowed us to determine a cost-benefit ratio of the euro and to derive how great the political benefits should be in order to make the pro-euro decision grand-efficient. Moreover, since such political benefits are necessarily arbitrary and can hardly be quantified, the political class and the euro winners' group have shielded themselves successfully against any criticism. In

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both cases, however, prospects are not very rosy: In the case where the distribution of benefits and costs is exclusive and B > C, the winners' group runs the risk of a radical societal split, dividing the society into one permanent camp of minority winners and another permanent camp of majority losers. It can hardly be expected, therefore, that such a social outcome would suit the perpetual guarantee of the euro and suit the fact that it is nearly impossible to exit from the membership of the euro club. Above all, it can hardly be expected that such an outcome would help to maintain social stability and mitigate against social unrest in Europe. Where B < C, and gains and losses are concentrated, it is equally hard to imagine that a communicable political benefit of sufficient size would be generated permanently to compensate the economic losses. Political peace is probably not the correct picture of the new Europe in the future. To the contrary, the new Europe will probably be characterized by new tensions and a revival of nationalism. There is no question that this is most certainly not the intended goal of the monetary union and the introduction of the euro. But at the same time, it is clear that a lot of things can go awry. Maybe the monetary union really is a primarily political operation or, to quote Martin Feldstein (1997b, 32), it is "based on a combination of broader political consideration and personal interests rather than on the economic merits of the case." Karl Kraus, Vienna's famous satirist, once said in his unique way: "Diplomacy is a game of chess wherein the peoples are checkmated."

Notes

1. Still, fourteen months after the introduction of the euro, the percentage of euro opponents in the population has not declined, as a recent Forsa survey shows (DM-Online 2000).

2. Most evident in this respect is the list of signatures by 156 German economics professors in response to a pro-euro list of 53 economists in the fall of 1997 (Kösters

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et al. 1998). In the political arena, however, this formerly heated debate has been more or less ignored by the large national parties in favor of an overall consensus among them. For the recent academic discussion see, among others, Begg et al. (1998) and Bergeijk and Jansen (2000).

3. Peter Kenen (1969) pointed out that highly diversified economies are better able to absorb asymmetric shocks, as a lack of geographic mobility of factors can be substituted by a larger degree of interindustry mobility of factors.

4. GG = Grundgesetz, the German constitution.

5. The Greens, the CDU, the CSU (Christian Social Union, the Bavarian part of the CDU), and the FDP (Free Democratic Party, the Liberals) were against a referendum or considered this issue untenable because (according to the dominant opinion) the German constitution does not permit such a procedure. The Social Democrats blamed the Kohl government for having prevented the possibility of referenda in the context of constitutional reform. They, too, were against a referendum on the euro, however, on the grounds that it would be unconstitutional at the time. The parties of the extreme left (the PDS, the follow-up to the Communist Party in the former German Democratic Republic) and those of the extreme right (the DVU, the Republicans) were against the euro and for a referendum.

6. For a detailed discussion of this point, see Zimmermann and Just (2001). For a more detailed discussion of economic aspects of direct democratic elements, see, for example, Zimmermann and Just (2000).

7. A Forsa survey reports a similar result. While only 36 percent of the people with a high school degree have rejected the euro, 65 percent of the people with lower-school education opposed the project (DM-Online 2000).

8. It should be borne in mind that we are talking here about expected costs and benefits as seen by the individual.

9. A political counterargument might be that the problem lies in the underestimation of winners. This argument may be true to a certain degree, but the argument is counterproductive. With a rejection of the referendum by the political class, one always has reason to suspect that $C > B$ (or, more precisely, $C > B$ times the quotient of the losers' share and the difference between the majority necessary and the winners' share), and this implies that with a growing share of winners, the factor by which the costs outweigh the benefits increases, too.

10. All the more so since euro opponents, à la Feldstein, could bring the political-costs issue into the discussion with the argument that the euro would lead to greater political instability.

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