Introduction

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The essays collected in this volume address a host of issues related to the much-studied EU's fiscal and monetary institutions. The works date from 2001, a time when interacting breakthroughs in fiscal and monetary matters were under way that made possible the introduction of the euro in 2002.

What used to be called the EMS (European Monetary System) at the end of the 1970s is reckoned to have begun the process of institutional reforms which was gathering pace by the end of 1980s and which took off in the 1990s with the Maastricht Treaty (1992) and the Amsterdam Treaty (1997), with its Stability and Growth Pact.

Of this institutional productivity the present volume attempts to present a representative selection. And even those who are well informed can benefit from a clear account of aspects and solutions they may have taken for granted. Had the conference concerned itself only with a pure retrospective on fiscal and monetary institutions, the need for a volume might have seemed less pressing. The essays collected in this volume offer instead a perspective on a wide variety of current fiscal and monetary issues. These issues are discussed in nine chapters, each of which is made up of a presentation followed by one comment, in some cases two, except for Chapter 4. The comments are provocative and help readers to unearth subtleties and nuances underlying the various contributions.

The analysis of the *status quo* regarding institutions that have evolved in a two-decade span or more has inevitably led the authors to use an evolutionary approach. Yet, although this approach, a Hayekian evolutionary position as such is not to be found in their analyses. Despite the obvious differences in style and contents of the various contributions, the theme that is voiced throughout the volume is the need for a fiscal constitution. No appeal could be more appropriate now that a constitutional convention is working.

The first part of the volume, 'The underside of EU fiscal institutions: budget, deficit, debt and regulation', is made up of four chapters and deals with various fiscal issues. In the opening chapter, Fabrizio Balassone and Daniele Franco elucidate to what extent EMU's (European Monetary Union's) past achievements have made headway in the field of public finance. To this end, they review the literature on budgetary rules from its very beginning to the years immediately before the Treaty of Maastricht. They consider a host of issues. In particular they deal with the arguments brought forward to justify EMU fiscal rules and identify the newness of the issue faced by the EU as a multinational structure suffering from lack of a federal organization. According to the authors, moral hazard sprang from the highly decentralized setting of fiscal policy in EMU and is responsible for having induced the rejection of both the dual budget approach and the distinction between ordinary and extraordinary finance. Such a scenario was a big push towards the adoption of a detailed multilateral surveillance procedure as well as predetermined limits for the annual deficit with the aim of achieving a balanced budget over the cycle.

In Chapter 2, Peter Bernholz attempts to shed light on the financial situation of the member states of the European Union. The improvement of the deficit and debt situation, maintains the author, has been positively influenced by the conditions of the Maastricht Treaty and the Stability Pact, as well as by the favourable phase of the business cycle. However, this is not a smooth process. Most of the countries that are candidates for membership still perform well below those criteria. And he suggests that in order not to endanger the fiscal situation of the EU, they should be admitted only after fulfilling those requirements. The central budget of the EU, on the other hand, already provides for additional expenses linked to the transition period after membership has been granted. Furthermore, the author addresses the potential impact of the ageing of the population on the fiscal stability of the Union due to the old age pension systems of the member states. He therefore urges more radical reforms.

Giuseppe Eusepi tackles the question of a federal solution for the EU in Chapter 3. Within this framework the author analyses the two contrasting views of tax harmonization and tax competition, which he denotes as the orthodox approach and the constitutional approach respectively. In his view the first approach conceives of government as a maximizer of social welfare, the second as a revenue maximizer. Eusepi takes a theoretical position that exposes how the so-called tax harmonization among EU member states is in reality a cover-up for an EU welfare state, which is almost impossible to cope with at an individual member-state level. He invites readers to question the misleading assumption behind the harmonization procedure seen as a tool to prevent externalities. In his view, even accepting the paradigm of a benevolent omniscient government, with harmonization the EU is cutting its coat according to the cloth of a supranational welfare state. He then argues that a fiscal constitution would, through fiscal competition, shrink government size and would lead to a fiscal equilibrium with consequent economic growth.

A chapter by Geoffrey Brennan concludes the first part. He emphasizes that regulation represents one possible 'policy technology', to be contrasted with budgetary operations in a number of ways. He directs attention to the significance of public revenue constraints on the operation of governments and the way in which regulation might be seen to finesse those revenue constraints. The implications of the 'power to regulate' for public activity in an era of increasing globalization are explored. In particular, he confronts the standard or public economics approach with the public choice approach. On the first front, he notes that regulations do not induce excess burdens between taxed and untaxed activities that are features of budgetary policy. Thus, the superiority of budgetary policy over regulations, which standard public economics assumes, cannot be accepted. From the public choice viewpoint, regulation, at least in some cases, allows the exploitation of less organized and numerous groups, such as consumers and taxpayers. Moreover, regulation may be a way for the government to avoid the various disciplines that the budgetary process imposes. Hence, from the public choice perspective the picture emerging from the regulation/budgetary alternative is more complex and equivocal. Incentives to regulate arise from the escalating difficulties in raising revenues.

Part II, 'Becoming EURO: internal stability and international crises', examines the role that the EMU, based on the euro, can play. This is done from the perspective of both the EU's member states – by analysing the vicissitudes that have urged its construction – and from the wider world perspective characterized by the Asian financial crisis.

Pier Carlo Padoan in Chapter 5 highlights how early critics of EMU pointed to economic and institutional drawbacks of the project. The scenario they depicted was that the euro would not meet the requirements of an optimum currency area and would be plagued by the institutional disequilibrium between a supranational and an unaccountable central bank on the one side and national governments on the other. If proved true, both aspects would inevitably lead to the failure of the EMU project. The author, by using an evolutionary perspective, melds these two issues and argues that the evolution of the economic structure of EMU is pursuing a vigorous policy on many different fronts, working towards an efficient and viable European economic and institutional model.

Drawing upon 'endogenous currency areas', Padoan argues that monetary integration will enhance transformations in the integrating economies, thus making them eligible for the adoption of a single currency. Some evidence is provided by referring to the literature on the optimum currency area such as cyclical convergence, regional convergence, specialization and labour markets. He imparts a firm understanding of the evolution of these aspects under different monetary regimes and degrees of convergence in

Europe. He then seeks to point out, through the concept of policy spillover, that the centralization of monetary policy in Europe leads to changes in other policy areas, such as cooperation between the single monetary policy and national budget policies, budget cooperation in EU-12 and convergence towards a 'stable budget regime'. He foresees further development in convergence in other policy areas, such as tax policy and labour market policy. He also explores the great impact of macroeconomic and structural integration on economic policy regimes in Europe over the past decades and in turn on the endogeneity of the EMU currency area.

The problem of how best to approach the new situation that has arisen after the creation of the EMU and the Asian crisis is the focus of Schneider's Chapter 6. In the new scenario, he speculates on the prospects of a more powerful and effective international monetary organization. To address this new challenge, the new institution will need to be genuinely independent of its major donors so as to be prepared to act efficiently when called to assist countries in financial trouble. A related issue involves the role that this institution should play in controlling monetary policy and in providing instruments to intervene in countries' fiscal policies.

A provoking chapter by Gordon Tullock ends Part II. He addresses the important question of whether the euro is bound to fail or to survive. Tullock inadvertently teaches us to be cautious whenever the task of foreseeing 'future history' is undertaken. However, any forecasting error by a scholar can be more easily justified than any wrong evaluation of past history. It is from past history, the history of the Federal Reserve Bank – on which the ECB (European Central Bank) was modelled – that Tullock draws in trying to find answers to his question. He explores the background of the Federal Reserve Bank, which did very little (though European countries' central banks did even less) to cure the Great Depression and to stop inflation after World Wars I and II.

Moving from this premise, Tullock considers a host of questions. For example, he wonders whether the ECB would possess sufficient power to keep the euro stable if inflationary tensions were to occur due to a full-employment fiscal policy. His answer is in the negative. This is particularly worrisome since such a scenario is likely to loom on the horizon. Even though it is no longer at its height, the resilient Keynesian theory would reinvigorate and find governments' support. Should this happen, 'No amount of monetary discipline can compensate for fiscal folly', as Grofman writes in his comment quoting his colleague A Waffle.

Finally, Part III, 'Two issues at work: voting and contracting', is made up of two chapters that are tightly linked to the preceding parts. Specifically, Blankart and Mueller argue that many, if not most, parliamentary democracies are characterized by a parliament that is elected to represent the opinions of the population and a government that is elected by the parliament to execute a particular political programme. They believe that the combined application of the two procedures is necessarily imperfect and deviates more from voters' preferences than if only one of the procedures is applied. Explicit in the authors' discussion is the assumption linking unaccountable governments, voter alienation, strategic voting and governmental instability to this institutional mix. Blankart and Mueller's solution relies on a structure able to eliminate many of the imperfections through the introduction of two logically consistent models of parliamentary democracy: either a 'pure form of representative democracy' (PRD), where collective opinions are formed in the parliament, or a 'pure two-party form of representative democracy' (TPD), where the government programme is chosen by the voters.

In the concluding chapter, Martin Paldam, by using an Edgeworth box, examines a contract between a small country like Denmark and a large organization like the EU. To this end, he divides the population of the country into two groups: people and élite linked by a contract bearing two explicit parameters: an exchange of sovereignty and a net transfer. The author points out that in a small country the power people would obtain by entering the organization is infinitesimal, while the élite would perceive a net power gain. Despite the methodological difficulties, Paldam is able to draw convincing and provocative conclusions from his model.

It is customary among academics to conclude by underlining that there is still much work to be done. No conclusion would be more appropriate in our case. In fact, the chapters included in this volume do not depict only the fiscal and monetary *status quo*, but look into these issues and speculate on their prospects for the future. In particular, the EU must rethink the need for a fiscal constitution. This point is becoming of crucial importance with the enlargement of the EU and the opening up to other ten countries which will have the right to vote in 2004. The overall effect will be an increasing redistribution resulting in a crisis of the EU budget. This scenario would involve more regulation, as Brennan argues. While the creation of the ECB and the introduction of the euro are unquestionably one of the most successful steps in recent years, the works under way of the European Convention make us think that a fiscal constitution is unlikely to be included in the upcoming European constitution. The consequence will be that probable and perhaps deeper crises could be on the EU's doorstep.