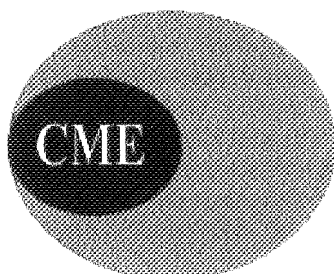


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Who enforces whom? The Political Economy of the EMU Fiscal Discipline

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Who enforces whom? The Political Economy of the EMU Fiscal Disciplineⁱ.

Requirements and possibilities

This article focuses on EMU fiscal discipline and centres on the question: Why have EU member governments chosen to submit their own domestic public budget to “collective monitoring, surveillance and enforcement”. If students of public budget, such as Wildawsky or Buchanan, would probably suggest that the best way to get balancing public budget is to adopt a domestically based constitutional rule. Students of EMU are likely to suggest that EMU fiscal disciplineⁱⁱ belongs, as other arrangements such as the creation of the European Central Bank, to the sort of international political economic relations (Molle, 1994; Crawford, 1996). National convergence policies make the major tissue of the European Union, and are likely to prove the willingness of EU countries to adopt an ever-closer political economic integration. The EMU fiscal discipline does not interfere with national fiscal authorities in their own way to make taxation and expenditure. However, it was necessary to put limits to public spending and to adopt an international monitoring, surveillance, and enforcement policy in order to avoid a free-riding problem (Gros, Thygesen 1998).

With certain nonchalance towards the convergence criteria 11 European Union countries proceeded to fixing irrevocably their exchange rates. From January 1 1999 the Euro became a parallel legal tender for 270-m. Europeans. It will become their single currency in 2002. Nonetheless, EMU fiscal criteria remain a highly controversial issue in that fiscal consolidation continues to be an objective difficult to get to. In 1999, a year after the introduction of the new currency, public deficit travelled to 1.6% at yearly base, while public debt is estimated to have declined only to 72.9 per cent (against 60 per cent of the EMU requirement). Meanwhile, member countries as Belgium and Italy are still bearing a 120 per cent debt ratio to GDP (ECB Monthly Bulletin, January 2000). These figures are specially striking when compared to the United States and Japan.

The share of government expenditure in GDP is significantly larger in the Euro area than in either Japan or the United States at 49 per cent against 39 per cent and 34 per cent respectively (ECB, January 2000). Persistent high government expenditure in the Euro area shows that the problem of fiscal discipline is not obsolete, as many economists would allow (Corsetti and Roubini 1993). The choice made by EU countries to adopt an international monitoring, surveillance and enforcement policy to solve the problem of fiscal discipline within the EMU area is a distinctive character of EMU project, and a sign of the peculiarity of the EMU arrangements.

The EMU provisions have set limits to fiscal deficit that has to be less than 3 per cent of GDP on yearly base. In addition, a “coordinating” body - the European Commission and the Council of Ministers – is given the power to monitor and to enforce the rules. When comparing the EMU approach to the domestically based constitutional rule, the EMU enforcement mechanism appears to be weaker and prone to colluding practice. As the Council of Ministers is given the role of taking the final decision in case of an acknowledged violation to the agreed rule, a question arises: who enforces whom? A political body is unlikely to inflict penalties to one of its member governments.

The above question raises a second one: Why have EU countries adopted such a weaker enforcement mechanism? A response provided in this Article is that the EMU model serves better the objective of the participating countries to circumvent market assessment, so as to leave more room for manoeuvre to deficit-spending-prone governments seeking political survival. The “international market pressure” argument is, indeed, central in understanding the EMU arrangements and member countries approach of making-policy in the Euro area (Andersen, Eliassen: 1999:10). The approach is very similar to other EMU practices, like the monetary policy that EMU countries have delegated to the supranational European Central Bank. Though the technicalities are different, the delegation of monetary policy to the ECB and the delegation of the fiscal discipline to a supranational set of bodies, represent a solution to the time inconsistency problem (Campanella 1997)

The Article’s major tenets are as follows:

1. The provisions of the international agreement Pact of Stability address the time inconsistency problems which affect the Euro-zone countries in their attempt to ensure international market credibility (long run benefits), without upsetting the short term calculations, essential to their own political survival. Thus, a solution to the credibility problem is provided.
2. Under fiscal discipline, market constituency believes that peer countries are willing to monitor sovereign debtors, and eventually to bail them out in case of liquidity crises.
3. Under the supranational monitoring and punishment provisions, the Euro nations have found a solution to a free-riding problem. In fact, admission to EMU third stage has not solved the problem of deficit-prone countries, as the latter, given their past negative fiscal record, could continue suffering from higher interest rates. Although a fixed exchange rate will place some constraints on inter-European competition, deficit-prone governments can take a breath as they are likely to enjoy reduced debt servicing costs and at the same time gain greater space for manoeuvre at a domestic level.

EMU in practice

The general principles and procedures of the Treaty have been spelled out in detail in secondary legislation, which forms the so-called "Stability and Growth Pact".

Article 104c of the Treaty on European Union at the outset states that, in the third and final stage of EMU, "Member States shall avoid excessive government deficits". The compliance of a Member State with the budgetary discipline requirement will be assessed

inter alia on the basis of the level of the government deficit as a share of GDP in relation to a reference value set by the "protocol on the Excessive Deficit Procedure" (Protocol 5 of the Treaty) at 3 per cent of GDP.

When there is an excessive deficit, a procedure aimed at reducing the deficit is initiated. This includes several steps involving increasing "pressure" on the Member State through recommendations and notice to take effective measures to correct the excessive deficit position. If such a correction does not take place, the Treaty foresees that sanctions may be applied to the member States participating in the EMU.

The 3 per cent threshold can be exceeded without causing an excessive deficit, but only under a restrictive set of conditions. In particular, three conditions must be met:

(a) exceptionality: the origin of the excess has to be outside of the normal range of situations;

(b) temporariness: the deficit is allowed to remain above 3 per cent of GDP only for a limited period of time;

(c) closeness: the deficit must remain close to the reference value.

In practice, the Treaty prescribes that the original cause of the rise of the deficit above 3 per cent ceiling must be exceptional, that the deficit must not, in any case, exceed this threshold by too much, and must promptly return below it, once the initial cause no longer applies. These three conditions have to apply simultaneously. The extent of the common subset of events that do not give rise to an excessive deficit depends on the degree of restriction with which these conditions are interpreted. The Treaty, however, does not specify the exact content of the three constraints. The Stability and Growth Pact gives a more precise interpretation of the conditions (a) and (b).

The core elements of the stability and growth pact include:

- setting time limits to the various steps of the Excessive Deficit procedure so as to speed it up, and where appropriate, impose sanctions within the calendar year in which the decision on the existence of the excessive deficit is taken;
- defining the meaning of the exceptionality and temporariness conditions;
- specifying the conditions in which sanctions will be applied and their scale.

The starting point of the Pact is that the EMU members should set medium-term budgetary targets which are "close-to-balance or in surplus", thus enabling them to respect the 3 per cent ceiling even during economic downturns. The exceptionality clause (condition a) can be called upon when the excess of the deficit over the reference value is due to an unusual event outside the control of the Member state in question and which has a major impact on the financial position of the general government. It can also apply if the deficit overrun takes place in the presence of a severe economic downturn. The latter case is considered "exceptional" if there is an annual fall in real GDP of at least 2 per cent.

An annual fall in GDP of less than 2 per cent could nevertheless be considered exceptional in the light of other evidence, such as the abruptness of the downturn or the accumulated loss of output relative to past trends. In any event, in evaluating whether the economic downturn is severe, the Member State will, as a rule, take an annual fall in real GDP of at least 0,75 per cent as a reference point. This condition recognises that, in the event of a harsh and persistent recession, the room for budgetary manoeuvre between close to balance and a deficit of 3 per cent of GDP may not be sufficient to cushion the negative effects of the shock in economic activity.

As to the temporary nature of the excess of the deficit over 3 per cent of GDP (condition b), the Pact allows it only insofar as the "exceptional" conditions mentioned above persist. If the Commission's budgetary forecast indicates that the deficit would not fall below the reference value in the year following the recession, the country would also

be considered to be in a situation of excessive deficit in the year of the recession because it had violated the "temporariness" clause.

The Pact does not deal with the closeness condition (condition c).

In order of "seriousness":

a) the no-problem case, in which, in spite of the recession, the deficit remains below the 0,75 per cent threshold;

b) the limited-problem case, in which, the deficit exceeds 3 per cent of GDP during the recession, but remains close to it and returns below it immediately after the recession: the three conditions mentioned above apply, hence no excessive deficit occurs;

c) the violation of the closeness condition, in which the deficit is pushed up well above the reference value, but promptly moves below it as soon as the recession is over; the country is in excessive deficit during the year of the recession, but no sanctions are imposed on it;

d) the violation of the temporariness clause, in which the deficit remains fairly close to the 3 per cent ceiling during the recession year, but as it does not move below it in the year after the recession, the country is in excessive deficit during the year of the recession and, unless effective measures to correct the deficit are implemented, there is a presumption that sanctions will be applied;

e) the double-violation case, in which both the temporariness and closeness conditions are not respected; there is an excessive deficit which, as in the previous case, could eventually lead to sanctions.

The decision so as whether or not an excessive deficit existed during the year of the recession is taken on the basis of figures for the recession year which are reported one year later. In order to avoid the imposition of sanctions, the Member State considered to have an excessive deficit has to take immediate action in the year in which the decision on the existence of an excessive deficit is taken. The correction of the deficit should be completed in the year following the identification of the excessive deficit, i.e. in order to

avoid sanctions, the Member State concerned should bring its deficit below the reference value within two years and one year after its identification, unless special circumstances are granted.

The Surveillance and Enforcement service defines the 3 per cent deficit target as an absolute target which must be met in every fiscal year, exemptions being approved in very rare circumstances. It includes an enforcement policy that requires non-interest bearing deposits for members found (during a six-monthly deficit review) to have a deficit in excess of 3 per cent of GDP. A fine can be imposed if the deficit violation persists for more than two years. The enforcement mechanism is structured as follows:

Early warning system: monitoring and surveillance.

The Commission and the Council will "study these programs and monitor member States' budgetary performances with reference to their medium-term objectives and adjustment paths with a view to giving early warning of any significant deterioration which might lead to an excessive deficit." Once the Excessive Deficit Procedure has been initiated the Council will, in accordance with paragraph 11 of article 104c of the Maastricht Treaty "impose sanctions on a prescribed scale".

Triggering the procedure. The Commission, invited to commit itself to prepare a report whenever the actual or planned government deficit exceeds the 3 per cent reference value, will, as a rule, consider an excess over the reference value resulting from an economic downturn to be exceptional only if there is an annual fall in real GDP of at least 2 per cent.

The Economic and financial Committee will formulate an opinion on the Commission's report within two weeks. Where it decides that an excessive deficit exists, the Council will make recommendations to the Member State concerned "with a view to bringing that situation to an end within a given period (Article 104c (7)). If a member State fails to act in compliance with the successive decisions of the Council under paragraphs 7 to 9 of Article 104c, the Council will (...) impose sanctions including a non-interest bearing deposit. These sanctions would be imposed within ten months of the

reporting of the figures notifying the existence on an deficit. The Stability Pact foresees an “expedited procedure (...) in the case of a deliberately planned deficit which the Council decides is excessive”.

Structure and scale of sanctions.

The Commission can take the following action on establishing that a government has not complied with the agreement:

1. A non-interest-bearing deposit
2. This deposit should be converted into a fine after two years if the deficit of the government concerned continues to be excessive.
3. When the excessive deficit results from non-compliance with the government deficit reference value, the amount of the deposit or fine will be made up of a fixed component equal to 0.2 per cent of GDP, and a variable component equal to one tenth of the excess of the deficit over the reference value of 3 per cent of GDP. There will be an upper limit of 0,5 per cent of GDP for the annual amount of deposits. The amount of the sanction will be based on outcomes for the first year in which the excessive deficit occurred.

Implementation.

The implementation of EXCESSIVE DEFICIT PROCEDURE is subject to a "European Council Resolution" being issued. Such a resolution would give strong political guidance to the Commission, the Council and the member states on the implementation of the procedures. Furthermore, the Pact introduces two regulatory provisions: one on strengthening the surveillance of budgetary positions as well as the surveillance and coordination of economic policies, and another one on speeding up and clarifying the implementation of the excessive deficit procedure.

Why converge?

Current literature on EMU fiscal discipline mirrors the intrinsic difficulties of the problem. Three main questions are of interest to this paper: a) whether or not a fiscal discipline is desirable, and for what purpose; b) whether the Pact can increase mutual trust or produce negative effects on relations among EMU members; c) whether or not the objectives of public budget discipline have been seriously sustained by appropriate institutional provisions.

All three questions rank high in EMU political economic literature but perhaps only the last two are of direct interest to EU policy-makers. The first obviously relates to the economic performance that the introduction of a balanced budget discipline can bring about to economies that have only recently started their transition to an open-market policy. The second one relates appropriately to the political relations among member states, and between them and the domestic electorate, which has not been allowed to express their own preferences for a single currency through the ballot box. The third question relates to the effectiveness of the fiscal institutions when they are embodied in a macroeconomic policy; favouring a macro discipline can raise doubts about the real willingness of these institutions to follow through with their announced objectives.

A declared objective of the Stability Pact is to insulate the future ECB from possible inflationary pressures. For this reason, hard currency countries recognise that the relationship between monetary and fiscal policy plays a crucial role. As anticipated by Sargent and Wallace (1981), the way in which monetary and fiscal policy is coordinated affects the Central Bank's ability to control inflation. Fiscal deficits can be financed either by seignorage (inflation) or by bond sales. If monetary policy dominates fiscal policy, then the monetary authorities can set monetary policy independently, and the fiscal authorities would have to finance the deficit by a fixed amount of seignorage (determined by the monetary authorities) and by bond sales. As monetary authorities (independent central banks) are free to choose the path for the monetary base, they can permanently control inflation. If, however, fiscal policy dominates monetary policy, the fiscal authorities could set the budget deficit independently, and the monetary authorities would be constrained to finance the difference between bond sales and the budget deficit. In this

case, the monetary authorities would have less power to control inflation (Brociner, Levine 1991:8).

Sargent and Wallace suggest that "monetary policy be designed to dominate fiscal policy, for the control of inflation. EMU treaties have created the ECB, as the monetary authority, which should decide on monetary policy independently, so that the fiscal authorities (or authority) would then be limited in the financing of their deficits.

"Knowing that they would have no recourse to monetary financing would also impose a discipline on the fiscal authorities to set a deficit compatible with their available source of financing. And the ECB could more reputably, and therefore successfully, achieve its goal of price stability"(Brociner, Levine 1991:20).

Arguments in favour of the introduction of a Community-wide fiscal discipline originate from the various governments' long-lasting divergent behaviour in public spending, net government lending, and gross public debt in the 80s and 90s. In the beginning of the 60s, -as Von Hagen finds- "there was a remarkable similarity among the six EC Member States and Ireland, Denmark and the UK. Expenditure varied between 25 and 35 per cent of GDP "at the end of the decade. After the oil shocks in the 70s, there was an acceleration of expenditure relative to GDP. In the early 80s expenditure ratios peaked, except for " Greece, Spain and Italy [which] maintained positively trending expenditure ratios throughout the decade"(Von Hagen 1993:43).

The need to protect participant countries in the single currency area from the consequences of an excessive borrowing country is assessed in different ways in economic literature. Some authors detect negative externalities of excessive borrowing in three main sectors:

1. If a country's level of public debt becomes unsustainable, other members may be politically obliged to bail-out the member in crisis - despite the "no-bail-out clause" provision of Article 104 of Maastricht Treaty - thereby creating generalised "moral hazard" incentives for all nations to over-borrow.
2. Because, of financial interdependencies, a failure to affect a bailout may lead to a Community-wide banking and financial crisisⁱⁱⁱ.
3. Bail-out issues aside, excessive borrowing by one member nation

may raise government interest rates elsewhere in the Community, a pecuniary externality with real (but secondary) effects when inefficient taxes have to be levied to repay debt.

The scope and range of the EMU discipline has raised doubts on whether a numerical target of 3 per cent is tenable in economic terms. Though estimation of average public expenditure in the EC is acknowledged to range around 3 per cent of GDP, some economists question the economic rationality of the deficit criterion as it "implicitly amounts to a current balanced budget rule, i.e. the current revenues should equal current expenditure"(Corsetti, Roubini 1993:119). Regardless the fact that institutions imposing fiscal discipline are warmly recommended at a national level (Von Hagen 1993), they are rejected at a Community-wide level on the premise that they cannot perform appropriately (Eichengreen, Von Hagen 1996). Firstly, restrictions on public deficits seem to be unnecessary if member states in a "federal union" still control taxes (Bayoumi, Eichengreen, and Von Hagen 1997). According to Eichengreen and Von Hagen (1996), the act of declaiming a fixed benchmark is the same as intensifying pressure at Union level to offset country-specific shocks that an unrestrained national budget would have managed autonomously. In the present EU, Eichengreen and Von Hagen (1996) consider fiscal restrictions to be redundant and dangerous. By controlling the overall level of taxes in the EU, there will be the option of no default and therefore no pressure for bailing out. In the event of financial difficulties, governments can resort to a "third" option: to raise their own taxes. "The fact that this third option exists will buttress the credibility of the ECB's no bail out rule".

Secondly, the excessive deficit procedure- as Von Hagen argues- "is worse than redundant: it will aggravate the very problem it is designed to avert. If tax-smoothing and automatic-stabilisation capacities of national governments are hamstrung, national officials will lobby for these services to be provided by the EU, leading to the transfer to member states"(Von Hagen 1993:137). Political pressures on the EU institutions, the EU Commission and Council are likely to increase.

In a different way, students who focus attention on political biases in fiscal policy appreciate the introduction of a fiscal benchmark. The tendency of political governments

to run "excessive" fiscal deficits, which is likely to take place in the run up to an election, can discourage fiscal competition (Alesina and Perotti, 1996). Others, such as Alexander and Anker (1997), and Crawford (1996), who focus attention on time inconsistency problems make a similar assessment. In their case, the lower interest rates, which are expected in the new currency area, will probably encourage a looser budget policy.

A further rationale often called on to maintain Community-wide discipline derives from the political problem of how to reassure the domestic electorate that no harm will come to the whole area from the different national attitudes towards political beliefs and the size of national debt before entry. The underlying rationale of the fiscal criteria is that convergence regarding those reference values will make the European economy more efficient and subject to fewer variations in prices and production. However, important benefits from EMU will depend on how national budget policy adapts to the more demanding situation: solving domestic problems (budgetary autonomy) and responding to overall EC macroeconomic policy (coordination).

Compliance with the fiscal criteria, however, can be of limited in scope and consequences.^{iv} This is because it can be a straightforward instrumental policy aimed at winning credibility in financial markets so as to enjoy the benefits of lower interest rates. As is shown in the Italian case, the 2,7 per cent deficit of GDP which has gained Italy admission to the first (and indeed large) group of EMU, has been obtained principally because of the increased of credibility that financial markets have won for the country. The payoff has even been doubled as the political coalition in power has not been forced to avoid cutting social transfers, a fact that has rescued its political unity from erosion (Alesina 1998).

The real payoff seems to come on the front of lower interest rates, while it does not seem to have led the EMU participating countries to introducing any irreversible structural changes in the dominant pattern of their distributive policies. The major difference can be synthesised very accurately in that before Maastricht distributive policies were funded by high public deficits and after Maastricht, they are funded by raising the tax burden.

How can an appropriate "virtuous" budgetary behaviour be encouraged at a national level? Are governments able to resist political pressures to run a virtuous budget policy if unemployment rates continue to increase? The first problem consists in assessing whether or not the two criteria (3 per cent deficit and 60 per cent debt to GDP) are linked together. The specialised literature on public spending has not yet reached a clear assessment. At least three main reasons are generally discussed - positively or negatively - when linking fiscal criteria (dimension of public debt and public deficit) to monetary criteria, the interest rate, inflation rate and exchange rate.

First, because a country's "excessive" (unsustainable) indebtedness may provoke a financial and fiscal crisis, such that other member states are obliged to relieve the members debt crisis and this despite the "no bail out provision" of Article 104b of Maastricht Treaty. A provision that is rooted in the principle that each member state is fully responsible for its own public deficit. However, EU member states or the ECB may be obliged under political pressures to bail out the guilty. Second, as a special case of the first, excessive indebtedness can affect price stability. In the case that an insolvency crisis does hit the whole European financial system, the ECB may be forced to inject liquidity into the system in order to guarantee that the payment system works. The ECB should act in such a case as a "lender of last resort" and the rescue may affect price stability in the Community. Thirdly, excessive indebtedness may cause harmful externalities. This is the case where the excessive borrowing of one Member State is likely to attract increasing shares of Community savings and as a consequence cause interest rates to increase in the other Community countries as well.

To summarise, at least two rationales make reference to fiscal discipline:

Box 2. Fiscal discipline: two rationales.

<p>1. The deficit limit is aimed at controlling potentially adverse <i>fiscal externalities</i> to the Community member states due to excessive borrowing by a single member state a) causing the ECB to pump up interest rates for all the area in order to offset inflationary pressures; or b) drawing speculative and investment capitals from other member</p>

countries. Expected outcome would be generating fiscal virtue plus economic coordination, and last but not least, trustworthiness.

2. The deficit discipline strikes at the heart of the position of *state intervention* in the EU member economies. By self-restraining public budget policy, the budget discipline calls for public expenditure and tax cuts, as well as for governments to be excluded from the economy at large.

Box 3. Fiscal discipline: three approaches:

1. Market discipline: capital liberalisation and risk premium on governments' obligations.
2. Constitutional rules: binding governments by means of constitutional balancing budget rule.
3. Supranational institution: peer group multilateral surveillance.

As the EMU has adopted a mixed stance in which some aspects of each of the above points are considered (Bayoumi, Goldstein, Woglom 1995:1047); it is right to ask whether the results conform to the announced objectives.

Market discipline hypothesis

The market discipline hypothesis offers a reply to those who argue that it is necessary to introduce a formally defined fiscal discipline to protect the ECB from inflationary pressures. This literature proposes that the Pact's objective of safeguarding monetary stability can be achieved better by private markets, which can exert a

considerable amount of discipline on individual countries. In the EMU, as countries cannot finance a deficit by printing money, they have to sell bonds. A country's credit-worthiness will be reflected in the real rate of interest (including a risk premium) set to attract investors. As the rate rises with the risk, the interest rate acts as a discipline imposed by the market mechanism on individual countries, thus making it difficult to coordinate fiscal policy.

The market discipline hypothesis, however, is more relevant under the ERM [Exchange Rate Mechanism], than under the EMU. In a mechanism that manages exchange rate parities part of the risk premium in the real rate of interest reflects the anticipated depreciation of the currency. Under a regime of fixed exchange rates, as the possibility of devaluation is removed, so is the associated risk premium. Moreover, as capital markets become integrated and capital becomes more mobile, only a small rise in the real rate of interest will be needed to attract capital. In an EMU regime, the integration of capital, an important aspect of capital globalisation, implies that a country that wants to finance its deficit by borrowing can draw on the savings of all member countries. But if all countries were to borrow, the fiscal deficits would lead to higher interest rates for all member countries (Bisignano 1996). This free rider problem represents an inefficient externality^v which could be removed by fiscal coordination. Such a conclusion favours an institutional solution as "much of the markets discipline on member governments will be lost with monetary union"(Bronciner, Levine 1991:11).

In the opinion of Giovannini and Spaventa (1990), the credibility gain from an EMU regime would facilitate a reduction in inflation without the cost of fiscal discipline. They also express doubts whether the market will exert much fiscal discipline. Applied to US states, the "market discipline hypothesis" has proved to be successful in placing constraints on the States' "debt wish" (Sbragia, 1996). As Bayoumi, Goldstein and Woglom (1995) argue the market discipline hypothesis poses problems even in the vintage American Federal context on two key-levels: "(1) By how much and how quickly do sovereign borrowers respond to [market -imposed default premia] incentives? (2) Are the incentives provided by [those incentives] sufficient? " (: 1052). Two weak points that

sovereign borrowers can exploit making things worse, or that can lead to an uncontrollable situation.

In conclusion, the limits of the market discipline approach are evidence that this approach is untenable at least in the initial period of EMU. Though it should be (and eventually will be) the favoured approach to national fiscal policy in the EU, national governments will continue to have fiscal responsibility for the foreseeable future. At the moment, however, it would seem that a "pure" and let alone market discipline is not a sufficient spur to fiscal discipline.

Another important section of the market discipline hypothesis relates to interest rate movement under the conditions of a single currency. Economic literature on the Stability Pact has focused attention on the consequences that a single interest rate is likely to have on the borrowing policy of EMU countries.

According to economic theory, in a system of fixed exchange rates with no possibility for realignments all national interest rates for loans of identical quality (time to maturity and risk liquidity) must be the same. Alexander and Anker focus on the convergence of interest rates in the 15 member countries before and after 1999 and question whether a single interest rate is likely to materialise in the Euro area.

Analysis of the interest convergence before 1999 shows a continuing spread between the 15 EMU countries. The authors observe a correlation between the volatility of exchange rates and the convergence of interest rates. They analyse the developments of short-term (3-month) interest rates in Italy and Germany in two distinct periods of time. In the period 1987-92 when no realignments took place, and 1992-1995 when successive speculative attacks on the lira put a lot of strain on the Italian currency. They find that the spread of interest rates is low in the period of stable exchange rates and is high in the period of frequent exchange rate realignments. Evidence from the period 1996 (November)-1998 (February) after the lira's re-admission to the ERM shows that the Italian interest rate spread steadily narrowed. In conclusion, the authors assume that before 1999 the interest spread correlates "to a large extent (to) expectations about exchange-rate changes", while after 1999, with fixed exchange rates and the exclusion of

realignments, and no country-specific risk premium, interest rates should tend to be same. Under this new condition, however, lower interest rates can give rise to a situation in which weak governments extend their deficits by issuing bonds at the lower European interest rate.

Following the "market discipline hypothesis", the response of the markets should be to raise nominal interest rates against the excessive national borrowers. The higher interest rate is believed to place enough constraints on national governments so as to stop them from continuing debt-prone behaviour for a long time. Without considering for the moment the vagueness of this statement, which is analysed in the "time inconsistency dilemma", the rise of interest rates in the excessive borrowing countries is likely to cause spillover negative externalities as well. Raising nominal interest rates on a country's bond increases the expectations of a risk of default for these bonds. The first consequence is its effect on the balance of payments and the implications of future fiscal deficits. Spillover effects are observed in the global capital markets. Under conditions of growing liberalisation of capital markets, governments are largely inclined to finance budget deficits through foreign borrowing. A case often mentioned is that of USA in the 80s, which resorted largely to foreign borrowing to finance deficit budgets. At that time in the mid 80s, rising USA interest rates and high deficit obliged European central banks to raise interest rates, and eventually led for calls for a single currency (Henning, 1995).

Under the specific EMU-conditions, the incentive to foreign borrowing could be further enhanced by a uniform interest-rate set by the ECB and the absence of credit risk in the borrowing country.

This situation, described in the Muddle-Fleming hypothesis, states that "where there is free movement of capital and an immutably fixed exchange rate, fiscal expansion becomes more efficient because (1) the interest-elasticity of demand for the government's debt is greatly increased, due to the lack of the need for a devaluation-risk premium, and (2) the expansion is not choked off by a rise in exchange rate, as would occur with variable exchange rates if the central bank does not monetise the deficit." (Alexander, Anker 1996). Such concerns could be of little importance and rather trivial in the case of

a temporary fiscal expansion which the markets expect will be reversed. "Its importance" -as Crawford argues- "lies in an expansion (or contraction) which markets expect to be sustained for a long time. (...) Fiscal measures that are expected to be temporary do not carry the risk that the extra debt may have to be monetised, and therefore, where devaluation is possible, there need be no devaluation premium. Hence there is no difference (up to this point) between the EMU and the variable-rate scenarios in the case of a temporary expansion. But if a temporary expansion raises the level of prices and wages (relative to those in other countries) it will, in the EMU case, reduce real rates of interest in the country that takes the financial initiatives, since interest rates in all EMU countries are the same. This is not for long in a variable-rate scenario because nominal interest rates would rise as the demand for monetary and credit rose (due to both fiscal expansion and lower real rates of interest)" (Crawford 1996:298).

In conclusion, the market discipline hypothesis will be reversed, as markets are likely to accommodate the sovereign borrowers demand.

Domestic constitutional rules or international coordination?

This section discusses EMU fiscal discipline against the background of a domestically based model, i.e. the Balanced Budget Rule model. Following studies of fiscal discipline (Buchanan, Wildawsky and others), the model informs itself to the rule that fiscal discipline should be enforced by a constitutional rule at domestic level. Students of optimal contract add evidence to the above thesis and suggest that policy coordination would be enforced by "domestic institutional arrangements, not by an international agreement, and would not raise problems of sustainability, neither any country would have an incentive to deviate from the optimal contract "(Persson, Tabellini 1995 in Muscatelli 1997:123). Similar conclusions can be drawn from comparative studies of the Balanced Budget Rule. Von Hagen (1993), following Buchanan and Wildawsk, finds that fiscal discipline is pursued better through domestic institutions and at a constitutional level.

When the Pact of Stability is analysed against the background of these results, students observe that the EMU peer surveillance policy and the procedure of punishment are substantially managed by those to whom the Pact assigns the responsibility of imposing the final (if any) punishment. Inman (1996) spells out the weaknesses of the trigger mechanism embodied in the Pact and argue for a mid-range solution that can improve its enforcement performance. In his conclusion, the Pact's enforcement mechanism is politically biased, which means that it is unlikely to provide an effective fiscal discipline (Inman, 1996).

Comparative studies on fiscal institutions find that budget procedures and budget institutions do influence budget outcomes. Budget institutions include both procedural rules and balanced budget laws. Analysts of Balanced Budget Rules claim that for a balanced budget rule to be effective some important provisions are essential. These should be 1) ex post deficit accounting; 2) constitutionally grounded rules; 3) enforcement by an open and politically independent review panel or court which can impose significant sanctions when there are violations; 4. a costly amendment procedure (Bohn and Inman 1996; Inman, 1996). EMU budget fiscal discipline can be correctly compared to a balanced budget rule case as it establishes that a public deficit lower than 3 per cent is the benchmark of public borrowing and there is a set of enforcement policies. When these procedures, however, are compared to the standard strong balanced budget rule, EMU discipline appears to be a mix of weak and strong features.

EMU fiscal discipline as a balanced budget rule is considered to be strong as the timing review is required ex post: it should also be considered as strong because override cannot be approved of through majority rules. The amendment process is strong, too, in that it is difficult and costly.

EMU fiscal discipline as a balanced budget rule is weak in that it sets a feeble enforcement procedure: access is closed, the enforcer is partisan and the penalties, though large, are difficult to assess. Those weaknesses are particularly important as they come from the institutional and political framework within which the Stability Pact is set.

Zooming on the “institutional environment” within which the decision procedure is to be initiated, politically self-interested parties are seen in:

A) Access to the violation procedure is closed, as it is limited to the Commission's initiative. The Commission Report to the Council of Ministers is peremptorily designed to initiate the excessive deficit procedure against a nation that violates of the deficit benchmark (Article 104. C.2).

B) Though the Commission is generally defined as a supranational institution, it plays “as a partisan enforcer, whose interest is to seek the largest possible EMU” (Gros 1995). Evidence of this inclusive attitude comes from the Commission Report on third stage convergence (March 1998) which is more benevolent than the EMI Report. Though the two institutions seem close, in that they share “supranational features”, the Commission has a stronger interest to pursue an all-inclusive and no-conflictual policy which will allow it to gain momentum as the depository of the European political design.

As Inman predicts the Commission is “unlikely to interpret the guidelines strictly to allow open access to others to bring a balanced budget rule violation. Even if charges of violation are made, the inability of the Council of Finance Ministers (ECOFIN) to impose even modest spending guidelines on current violators (e.g. Greece) suggests the political will is lacking to act as an independent enforcer of a balanced budget rule” (Inman 1996:28).

C) Penalties are also weak. Violating nations are required to disclose additional fiscal information before issuing new debt. The European Investment Bank may withhold funds, but only a few EU countries receive significant funding from the Bank. Finally, the Council Ministers may impose fines or call for non-interest bearing deposits, but these are unlikely to be significant with a partisan enforcer. As Gros concludes: “With closed access, a partisan enforcer, and small penalties, the EMU current 3 per cent rule is, at best, a weak balanced budget rule” (Inman 1996:30-31). Though the Amsterdam Conference made an attempt to attenuate the concern and the increasing signs of disaffection of the German public against EMU and Euro, the Pact of Stability shares several features with its predecessor, it differs as to budgetary position in that it is now

subject to a more severe monitoring, which includes a compulsory mini budget when a divergence is detected with the approved Stability Program. The procedure of enforcement has been speeded up and more severe sanctions are imposed on violating member states. The new fiscal discipline has been strengthened in three ways:

* Timing: the **initiating actor**, the **Commission**, which is the institutional agenda setter for all decisions to be made by the Council, expresses an opinion and makes recommendation to the Council. The **policing actor**, the **Council of Ministers**, establishes a deadline for the correction of the fiscal budget, which “should be completed in the year following its identification unless there are special circumstances”. The Council's recommendation is made public immediately after the deadline set in accordance with Article 3 expires (4).

** Warning policy: early warning and **public** recommendation;

*** Pecuniary Sanctions: Section 4 Art. 11, 12, 13, 14, 15, 16. Deposits or fines will be made up of a fixed component equal to 0,2 per cent of GDP, and a variable component equal to one tenth of the excess of the deficit above the reference value of 3 per cent of GDP. There will be an upper limit of 0,5 per cent of GDP for the annual amount of deposits. The amount of the sanction will be based on the outcome for the year in which the excessive deficit occurred.

When the new provisions are assessed one question immediately comes to mind: Is it possible to strengthen the enforcement procedure?

At first glance, it seems that the only very new factor that adds real pressure on a violating nation seems to be the decision to make the recommendations of the Commission and the Council public. Publicity can indeed open the eyes of public opinion a little more, especially of private markets so as to re-admit them as “ a market enforcer ”. Though to a small degree, publicity can add some strength to the Commission’s and Council’s early warning. The remaining two provisions, which are indeed huge if they

are really applied, have to get political approval, which means a deadlock which can only result in a politically induced delay.

To summarise, against the background of standard strong balanced budget rule, the new EMU fiscal discipline does not really reverse the assessment made above about the Excessive Deficit Procedure¹. The enforcement procedure is not strengthened by tougher pecuniary sanctions, it is still enfeebled by a triggering mechanism left in the hands of the European Council, a political institution *par excellence* which is unlikely to seriously self-inflict the announced sanctions.

Though this final Section does not claim to cover all possible alternative interpretations, it argues that cartel gains and collusion will eventually prevail in the future workings of EMU policies.

Implementation and enforcement.

Balancing the nation's public budget is a rather recent economic imperative in advanced industrial countries. For over five decades, since the end of the Second World War, the fiscal policy of most of the industrialised countries was inspired by Keynesian deficit spending and a certain propensity to run higher state deficits. As opponents to Keynesian theory would admit (Buchanan, Burton 1978), unanticipated political bias, due to pressures and incentives in government, parliament, and in the administrations towards over-expansion in public expenditure and deficit finance, have ended up in misinterpreting the scope and the aims of the original objective of Keynesian theory.

As several students have shown bureaucratic and ministerial pressures towards increased expenditure have even been reinforced by constituency level pressures, which in continental Europe have been translated into expensive "acquis sociaux" following a general convergence of left and right coalitions towards a model of a "social market economy".

Buchanan, Burton and Wildawsky focus on the political process of drawing up public budget policy, the conflicting interests emerging in the process of writing financial laws and the way the latter substantially affect the level of taxation and expenditure. In this context, students of “public choice” have collected historical series of public deficit figures, which show that higher public deficits are associated to the political cycle (elections). As Buchanan synthesises “fiscal policy is deeply involved with budgetary manipulation”, and as a consequence there is a necessary “linkage between any macro policy objectives and the whole process of public sector allocation”. The linkage indicates how difficult it is to introduce an independent watchdog institution (delegation) designed to protect fiscal and budget policy from the consequences of the political cycle. As Buchanan asserts: “Given this necessary linkage, and given the institutional-political history, it seems today unreal to suggest that any shift of authority over fiscal policy would be delegated to either a discretionary or even to a rule-bound authority. It seems highly unlikely that fiscal policy, in any sense, would be removed from the ordinary procedures of democratic decision-making, with divided legislative and executive responsibilities and roles in its overall formulation.” (Buchanan 1998: 51).

When assessed against a Buchanan’s like model, EMU fiscal discipline clearly lacks “democratic determination”. In this regard, EU shows to be an “undefined” political object:

Firstly, the EU is not-yet (or never to be) an accomplished polity.

- It lacks a central and political (elected) government. Such a full-fledged institution does not yet exist and the Commission of European Communities given its bureaucratic (non-elected) nature is unlikely to match it.
- The European Parliament, central and political (elected) body, is not provided with appropriate control power over member states public budget.

Secondly, differences with the USA relate to the effectiveness of the way to accomplish the objective of fiscal discipline. Though EMU has also provided the European Central Bank with legal independence (Campanella 1997), the “principle of

delegation” has not been granted to the European Commission, the monitoring and warning body of the Pact of Stability. If effectiveness were to be the real objective, the political bodies (the Council of Ministers) should be left very little room to manoeuvre on decision-making (Inman, 1996). Such a provision is perfectly compatible with multilateral surveillance, as “commitment technologies” (Von Hagen, 1993) can be given the task of monitoring for the objectives of “macroeconomic coordination”. This, however, is not found in the Pact of Stability that, instead, has left the power to initiate and to pursue the major steps of the enforcement procedure in the hands of the European Commission and of the Council of Ministers (Eichegreen, Wyshplosz, 1998).

In few words, the enforcement policy, which is the key point of any ‘international agreement’, lacks an appropriate independent enforcer, yet one is necessary if the policy is going to be successful. The political "intergovernmental" body, i.e. the Council of Ministers, which is designed to monitor and eventually take action against violating member countries, is unlikely to be given the necessary autonomy and independence that an independent enforcer requires.

Concluding remarks.

A major rationale for fiscal discipline is to prevent externalities arising from independent fiscal policies that can be too expansionary or sub-optimal (Brociner and Levine 1993). In the case studied in this article, fiscal discipline among EMU countries has taken the shape of fiscal coordination, especially when the enforcement mechanism is left in the hands of the interested parties (member governments in the Council of Ministers). Muscatelli (1997:116) warns about fiscal coordination: "If we want to explain what motivates fiscal policy, we ultimately have to look to political preferences and electoral objectives as key driving forces. Thus, governments may pursue distorted policies as they have partisan objectives (policy objectives which match the preferences of a part of society), or because they are office-motivated and are pursuing short-term benefits for electoral purposes. When co-operating over fiscal policies such governments may collude against the interests of the private sector (...)". This means that the latter

and the declared objectives of the international agreements cannot openly proclaim to counter private market economy in their capability to impinge on the fiscal policy-making, which are at hearth of politicians in power. Colluding against the private sector can easily be a joint Pareto payoff that nobody is willing to give up.

Though the Pact of Stability sees some European supranational institutions get involved in the assessment of fiscal performance, it has left out the European Commission, a supranational institution, to take initiative on the enforcement mechanisms. As a consequence, the efficacy of the EMU fiscal discipline raises two distinct problems: 1. Politicisation of the triggering mechanism, which enfeebles the implementation of the sanctions. 2. The “left-out players problem” which raises doubts about the democratic legitimacy of international macroeconomic policy. International agreements as far as they do not take into account the consequences that their policies are likely to cause to parties not involved in the negotiating process can originate colluding practice (Vaubel, 1985:25). Though neo-realist theories seem to account for so many aspects of EMU grand projects, they can be unequipped to face the colluding practice that is implied in “joint Pareto gains”.

This article has analysed the case of the Excessive Deficit Procedure², which is intended to strengthen the fiscal discipline within the Euro area. It has raised doubts on the capability of supranational institutionalist approach to explain why the EMU governments have committed to fiscal discipline by means of an international institute and why they have purposely weakened it by retaining power on final decision. What supranational institutionalism could describe in terms of “Pareto (improving) joint gains” might easily turn to be a move to get “cartel gains” or simply to arrange for “collusion”.

ⁱ First drafts of this article have been presented in a Seminar at the West European Studies Program and at the ECSA Conference in Seattle(1997). The author wants to thanks Franco Reviglio, M. Guglielmina Tenaglia-Ambrosini, Alberta Sbragia, and Roland Vaubel for useful comments.

ⁱⁱ By excessive deficit procedure is intended the fiscal discipline embodied in the Pact of Stability and Growth subscribed by the Council of European Ministers on July 1997, in Amsterdam. When the author refers to excessive deficit procedure, the fiscal discipline is intended as the one detailed in the Treaty of Economic and Monetary Union, Maastricht 1991 approved January 1992.

ⁱⁱⁱMcKinnon (1996) suggests that a bailout risk will be most intense at the start; Eichengreen and Von Hagen (1996) argue that it will be least at the outset.

^{iv}A major critique towards the importance of the balanced budget rule is raised by M. Friedman (1995) who has recently remarked that “he would living in a world in which the government spends \$1 trillion a year and finances his spending partly through borrowing, to one in which the government spends \$2 trillion a year but keeps its budget in balance”. In Friedman’ s reasoning, it is clear that the harmful effects on the economy are caused by current spending and current taxes and not by the public budget deficit per se. Friedman and Friedman 1984. See also, Razzolini and Shughart II (1997: 216).

^vIn a letter to the author, Prof. Roland Vaubel suggests to avoid the false impression that international interdependence through the world capital market has to be viewed as an “inefficient externality” and a source of “free rider problem”. I agree with this recommendation and with the statement “ Spillovers through the market are efficient unless you assume that governments have, and ought to have, more targets than instruments” (R. Vaubel ‘s letter to the author 29.09.1998).

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