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Fiscal Discipline in the Monetary Union: Rules or Institutions?

CHARLES WYPLOSZ

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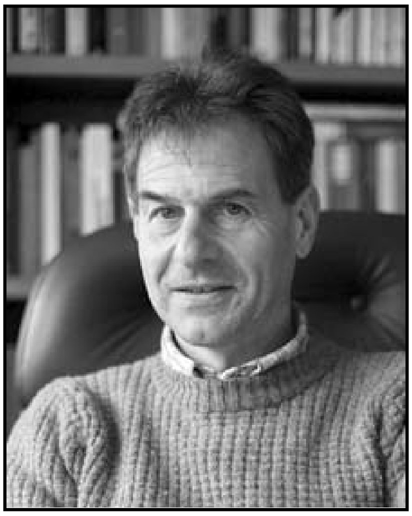

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Contents

Fiscal Discipline in EMU: Rules or Institutions?

1. Introduction

Three years after the launch of EMU, the Growth and Stability Pact – which implements the EDP – is even more controversial than when it was announced. Official and academic criticism is strengthened by the controversies which have arisen and which have confirmed key weaknesses of the Pact: arbitrary ceilings, political implementation, asymmetric effect over the cycle. Other previously identified weaknesses have not yet come to the fore, but will eventually do. The conflict with subsidiarity has been muted mainly because the Pact has generally been ignored during the national process. The political impossibility of imposing fines has not yet been tested.

As we search for ways of improving fiscal discipline in Europe, two paths are possible. The first one calls for refining the GSP, the second one urges a paradigm shift. Fixing up the GSP may seem as the practical approach, maybe the only feasible one. Feasibility here refers to perceived political constraints, not to economic effectiveness; the rules approach (quantified targets), backed by peer pressure (the BEPG), is unlikely ever to work satisfactorily. Europe has many other unsatisfactory arrangements which, over time, become sacred cows, so this is one chance to avoid enshrining the GSP, a basically flawed concept. This note argues that institutions work better, and explains how fiscal discipline can be achieved through appropriate reform.

The nest section briefly reviews the output stabilization record of fiscal policy. Section 3 takes stock of our understanding of how fiscal policy works, and how it compares to monetary policy. It draws lessons for reviving an instrument that has been vilified for the wrong reasons. Section 4 compares rules-based with institutionbased fiscal discipline, strongly supporting the latter over the former. Section 5 examines how institution-based fiscal discipline could be implemented. How this would work in EMU is the object of Section 6. The conclusions are presented in Section 7.

2. Fiscal Policies: The Stabilizing Record

Fiscal policy is criticized for being inefficient. In particular, it is claimed, the combination of lags (recognition, decision and implementation) and economicallymisguided political motives[1] often result in actions that exacerbate business cycles instead of dampening them. The European Commission (2001) – see also Buti at al. (1997) – claims that fiscal policies in Europe have been characterized by "pro-cyclical

activism". This conclusion is based on a graphical analysis where the 1990s play an important role. Melitz (2000) finds instead that they are counter-cyclical, but to a much smaller extent than previously believed. [2]

This section examines the record by estimating the statistical linkage between fiscal policy and business cycles in four countries: the US, France, Germany and Italy. The record is important because if policy has indeed been countercyclical, forfeiting discretionary action and relying solely on the automatic stabilizers would already represent a significant improvement.

In order to detect the cyclical characteristics of fiscal policies, three budgetary indicators – public spending, public revenue and the budget balance (revenue less spending) – are regressed against their own lags as well as the output gap (actual less potential GDP as estimated by the OECD).[3] If fiscal policy is counter-cyclical we expect that, when the output gap increases, spending declines, revenue increases, and therefore the budget balance increases too.

The results shown in Table 1 also test two frequently suggested hypotheses:

> First, it is asserted that fiscal policy is asymmetric over the cycle, being more relaxed in downswings than it is tightened in upswings. This can be tested by allowing the output gap to enter separately in years when it is declining (the gap is interacted with a dummy variable which takes the value of 1 when the gap declines, 0 when it increases). A stronger counter-cyclical reaction in downswings would correspond to the interacted gap variable appearing with a coefficient of the same sign as the gap itself.
>
> Second, it examines formally the claim that, over the 1990s, to meet the Maastricht convergence criteria until 1998 and then the Stability Pact requirement, debt stabilization has led to a lesser counter-cyclical use of fiscal policy, possibly even to fiscal policy becoming pro-cyclical. To test for this possibility, the output gap is also interacted with a dummy variable that takes the value 1 over the period 1992-2001, 0 otherwise. Pro-cyclicality would require the corresponding coefficients to be of the opposite signs and larger than those obtained for the output gap alone. If the coefficients are smaller but of the same sign, we would conclude that fiscal policy remains countercyclical, but weaker. It could also be expected that during 1999-2001 fiscal policy has been less smooth. This is tested by checking whether the coefficient of the lagged dependent variable is negative when interacted with the same dummy. [4]

Fiscal policy is also criticized for lacking discipline, which explains the spectacular buildup of public debts over the last three decades. A proper conduct of fiscal policy, instead, would avoid long-run debt buildup and, if it arises, would then call for subsequent adjustment. In order to test for the debt-stabilization motive, the lagged debt-to-GDP ratio is added on the right hand-side. If fiscal policy is systematically adjusted to reduce the public debt when it has risen, we expect to see a negative coefficient in the spending regression, a positive sign in the revenue regression, and a positive sign in the budget balance regression.

On a technical level, it can be objected that the variables used are not statistically stationary. In order to meet this objection, for each of the three policy indicators, Table 1 displays two regressions: in the first one all variables are used in level, in the second one they are all – including the gap – first-differenced.

2.1. Budgets are (moderately) counter-cyclical

The evidence shows that the budget balance is systematically counter-cyclical in Italy and the US - where a 1 percentage point decrease in GDP is met in the short run with a decline in the deficit of 0.4% to 0.5% of GDP. The effect is weaker (about 0.2) and very imprecisely estimated for France. It is negligible for Germany where, however, the response is found to be asymmetric, with a relatively strong counter-cyclical reaction in downswings, but at best a weak correction in upswings.

2.2. Public spending is counter-cyclical and revenues are pro-cyclical

Spending is counter-cyclical, and revenues are either acyclical (Italy, US) or procyclical (France, Germany). This may come as surprise, since taxes are thought to be the main channel for the automatic stabilizers. As Melitz (2000) observes, some taxes may indeed be sensitive to cyclical conditions, but when all public revenues are put together, the automatic stabilizers may be systematically thwarted by discrete policy actions on other taxes. The combination of counter-with the downswing dummy suggest more counter-cyclicality during downswings, but they are never statistically significant. The exception is Germany where procyclicality during the downswing cannot be ruled out, and can be traced back to public revenues.

Table 1. Cyclical Behavior of Fiscal Policy

USA

	Public spending		Public revenue		Budget Balance	
	Change	Level	Change	Level	Change	Level
Dependent (-1)		0.48		0.69		0.42
		3.24		3.69		3.15
D92-01*Dependent (-1)		-0.04		0.01		-0.51
		-2.51		0.55		-2.92
Output Gap	-0.38	-0.37	0.02	0.05	0.40	0.44
	-3.04	-3.17	0.15	0.86	1.86	3.73
Downswing*Output	-0.01	-0.06	0.09	0.03	0.10	0.03
	-0.03	-0.45	0.47	0.37	0.29	0.18
D92-01*Output Gap	-0.01	-0.30	-0.10	0.18	-0.09	1.52
	-0.02	-1.55	-0.29	0.95	-0.16	3.71
D92-01* Downswing*Output	0.53	0.46	0.37	-0.09	-0.17	0.23
	0.63	1.05	0.43	-0.26	-0.12	0.43
Debt Lagged	-0.02	0.09	0.00	0.01	0.02	-0.06
	-1.74	2.60	0.21	0.82	1.14	-2.45
Adjusted R2	0.71	0.89	-0.06	0.82	0.52	0.88
Standard Error	0.52	0.63	0.52	0.47	0.90	0.75
D.W.	2.20	1.59	2.49	2.21	2.42	2.33
N. observations	1971-2001		1971-2001		1971-2001	
Sample	31		31		31	

Table 2. Cyclical Behavior of Fiscal Policy

France

	Public spending		Public revenue		Budget Balance	
	Change	Level	Change	Level	Change	Level
Dependent (-1)		0.88		0.68		0.24
		8.72		5.27		0.91
D92-01*Dependent (-1)		0.04		0.00		0.77
		3.33		-0.38		3.18
Output Gap	-0.51	-0.02	-0.48	-0.12	0.03	0.20
	-1.95	-0.12	-1.59	-0.80	0.07	1.25
Downswing*Output	0.10	-0.20	0.20	-0.11	0.10	-0.01
	0.22	-1.19	0.38	-0.66	0.15	-0.07
D92-01*Output Gap	0.73	-0.06	0.05	-0.11	-0.68	-0.45
	1.48	-0.22	0.10	-0.41	-0.95	-1.18
D92-01*	-1.30	0.17	0.09	0.10	1.40	0.06
Downswing*Output	-1.91	0.58	0.12	0.38	1.41	0.19
Debt Lagged	-0.05	-0.10	-0.01	0.03	0.04	0.06
	-3.35	-3.45	-0.48	0.94	1.93	3.20
Adjusted R2	0.67	0.94	0.18	0.90	0.18	0.70
Standard Error	0.60	0.69	0.69	0.65	0.86	0.79
D.W.	2.01	1.74	2.24	2.17	2.20	1.52
N. observations	24		24		24	
Sample	1978-2001		1978-2001		1978-2001	

Table 3. Cyclical Behavior of Fiscal Policy

Germany

	Public spending		Public revenue		Budget Balance	
	Change	Level	Change	Level	Change	Level
Dependent (-1)		0.80		0.77		0.39
		9.50		6.32		2.20
D92-01*Dependent (-1)		0.03		0.02		0.30
		2.16		1.15		1.03
Output Gap	-0.25	-0.13	-0.35	-0.15	-0.10	0.05
	-1.18	-1.09	-1.62	-1.51	-0.33	0.35
Downswing*Output	-0.30	-0.08	0.56	0.10	0.86	0.20
	-0.90	-0.51	1.65	0.77	1.78	1.02
D92-01*Output Gap	0.31	0.17	-0.12	-0.03	-0.43	-0.17
	0.48	0.33	-0.17	-0.08	-0.45	-0.26
D92-01*	-0.33	-0.27	-0.26	-0.18	0.07	0.01
Downswing*Output	-0.43	-0.58	-0.33	-0.46	0.06	0.02
Debt Lagged	-0.03	-0.06	-0.03	-0.03	0.00	0.02
	-2.12	-2.97	-2.18	-1.50	-0.08	1.01
Adjusted R2	0.56	0.85	0.13	0.77	0.22	0.21
Standard Error	0.77	0.87	0.79	0.72	1.13	1.14
D.W.	1.48	1.79	2.31	2.49	2.18	1.77
N. observations	31		31		31	
Sample	1971-2001		1971-2001		1971-2001	

Table 4. Cyclical Behavior of Fiscal Policy

Italy

	Public spending		Public revenue		Budget Balance	
	Change	Level	Change	Level	Change	Level
Dependent (-1)		0.95		0.90		0.80
		7.49		7.23		6.57
D92-01*Dependent (-1)		-0.02		-0.02		0.05
		-0.58		-1.00		0.35
Output Gap	-0.60	-0.43	-0.09	-0.07	0.51	0.38
	-1.92	-1.60	-0.34	-0.44	1.44	1.65
Downswing*Output	-0.13	0.36	0.00	0.12	0.13	-0.23
	-0.27	0.83	0.00	0.47	0.24	-0.59
D92-01*Output Gap	-0.04	0.64	-0.78	0.71	-0.74	-0.55
	-0.05	0.59	-1.06	1.11	-0.76	-0.60
D92-01*	-0.60	-1.30	-0.15	-1.29	0.45	0.11
Downswing*Output	-0.50	-1.55	-0.14	-2.66	0.33	0.14
Debt Lagged	-0.03	-0.02	-0.01	0.03	0.02	0.03
	-2.47	-0.41	-0.64	0.91	1.71	1.96
Adjusted R2	0.63	0.92	0.18	0.98	0.42	0.77
Standard Error	1.16	1.74	0.99	0.99	1.31	1.56
D.W.	1.91	2.03	2.23	1.85	2.45	2.33
N. observations	31		31		31	
Sample	1971-2001		1971-2001		1971-2001	

2.4. Limited changes in the 1990s

There is no general pattern of changing cyclical behavior over the 1990s. German fiscal policy remains moderately pro-cyclical. In France spending and the overall budget, has become asymmetric, reacting counter-cyclically to downswings and procyclically to upswings. In Italy, spending is more counter-cyclical and taxation procyclical during downswings, with no net effect on the budget balance.[5] In the US, the deficit seems to have become considerably more counter-cyclical, although the evidence is not clear cut. This could be the coincidental result of the two "Clinton miracles": unusually fast growth and the end of the era of large federal deficits.

2.5. Debt exercises a disciplinary effect

In France and Italy, the public debt exerts a significant disciplinary effect on the size of the deficit. Except for the US (where the evidence is conflicting), spending declines when the debt rises. Germany, again, is the odd man out: both spending and revenues decline when the debt rises, with no significant effect on the overall budget balance.

3. Is There Any Future for Fiscal Policy?

3.1. Fiscal Policy Effectiveness

Can fiscal policy be used as a macroeconomic instrument without necessarily bringing about deficits and a growing debt? In theory, the answer is obviously positive: deficits can be balanced over the cycle while being as strongly countercyclical as appropriate. The record is less sanguine, as exemplified in the previous section. In spite of the automatic stabilizers, overall policy is weakly counter-cyclical, which suggests that discretionary policy is often pro-cyclical.

That discretionary policy has tended to be used at cross-purpose is not necessarily a fatal flaw, however. Current wisdom would ban discretionary action altogether relying solely on the automatic stabilizers. In most instances, that may prove to be sufficient, indeed better than over the recent past. But there will inevitably be circumstances where discretionary actions will be needed and could be effective, so current wisdom suffers from "GSP-type myopia", in reference to the GSP's escape clause that allows for so exceptional circumstances that it is effectively useless. What is needed is an enforcement mechanism that allows for some discretionary action only when needed.

Many countries, and the Eurozone, have established rules which do not rule out discretionary policy but binds it with rules. The problem with rules is that they tend to be rigid and artificial (arbitrary debt or deficit limits, golden rules based on thin air and falsifiable accounts), which makes them ultimately impossible to defend in the face of public opinions. A better response is to build institutions which create the proper incentives to achieve both short and long-term objectives.

3.2. Fiscal and Monetary Policies: A Fundamental Similarity

The challenge for fiscal policy, therefore, is to credibly combine long term commitments with short term flexibility. This challenge is not specific to fiscal policy. Monetary policy faces the same dual concern: it aims at delivering price stability in the long run, but it can help stabilize output in the short run. There is little today that monetary policy is an important and effective instrument. And yet, that has not always been the case. The crucial change that has rehabilitated monetary policy has been the move from rule design to institutional reform.

Back in the 1970s, the gradually dominating view was that the best way of running monetary policy is to follow a Friedman-type growth rule. The Bundesbank, among many other central banks, adopted this strategy and met early success. As time went by, however, flaws emerged and rules have fallen in disrepute.[6] The modern approach to central banking is to replace rules with adequate institutions. Following the lead of New Zealand, an increasing number of countries have delegated monetary policy to

independent Monetary Policy Committees (MPCs), which are assigned a clear task, that of maintaining price stability, while seeing to it that economic conditions are otherwise adequate.[7]

Fiscal policy is following similar lines, with a lag. Currently, rules dominate. Several countries have adopted rules: multiannual limits on spending have been introduced in the Netherlands, New Zealand, Sweden, the UK and the US, debt rules have been introduced in New Zealand and Poland. EMU member countries are subject to the Growth and Stability Pact.

3.3. Fiscal and Monetary Policies: Important Differences

In comparison with monetary policy, fiscal policy is relatively ineffective. Its impact rather slow and (too) long lasting, and it is also uncertain (Blanchard and Perotti, 2000). The debate on Ricardian equivalence underlines that much depends on how economic agents perceive fiscal policy actions. Temporary tax measures are understood to be largely ineffective, for agents adjust their saving behavior. "Permanent" tax measures are of limited credibility. Spending actions raise the question of how they are to be financed, which may elicit partially offsetting private reactions. In the extreme case where the debt path is seen as unsustainable, restrictive fiscal policies have been observed to exert an expansionary effect if they are seen as stabilizing an otherwise explosive public debt (Giavazzi, Jappelli and Pagano, 2000).

A complicating factor for fiscal policy is that assessing the budget constraint is not easy. Governments are held accountable to deliver both explicit and implicit entitlements such as welfare payments and the retirement of future generations. This complexity cannot be fully eliminated, but the effectiveness of fiscal policy can be enhanced by improving the visibility of implicit commitments and by eliminating offbudget items.

A further complicating factor is that fiscal policy is subject to democratic oversight. Every action has to be approved by the parliament. The result is a high degree of politicization which naturally involves differences of opinion but also open the door to lobbying by a myriad of interest groups that care little for the common public good.[8]

3.4. Lessons From Monetary Policy

Lesson No.1: less activism.

Fiscal policy is a less good instrument than monetary policy. Whenever monetary policy alone can deal with the situation, fiscal policy should remain inactive, relying only on the automatic stabilizers, certainly avoiding to become pro-cyclical.

Lesson No.2: long term debt sustainability ought to be a binding constraint.

Most modern central banks are given a clear, explicit mandate to aim at price stability. The equivalent long-term concern for fiscal policy is debt sustainability, and it ought to be made explicit.

Lesson No.3: qualified freedom over the business cycle.

Like monetary policy, once its long-term constraint is set and serves as an anchor, fiscal policy can be used as a counter-cyclical tool whenever it can make a contribution to economic (price and output) stability.

Lesson No.4: an ability to respond in real time.

Part of the advantage of monetary over fiscal policy is its speed of reaction. The counter-cyclical use of fiscal policy requires that the automatic stabilizers be powerful enough and, for discretionary actions, that the decision and implementation lags be sharply reduced.

Lesson No.5: long term commitments must be backed up by specific legal and/or operational arrangements.

Monetary policy is now typically subject to a clear long-term mandate via legal arrangements. The debt sustainability imperative of fiscal sustainability is rarely backed by a similar legal mandate. Europe's Stability and Growth Pact is quite unique in this respect.

4. Two Approaches to Debt Sustainability

A new fiscal policy framework must combine a credible commitment to long-run debt sustainability with sufficient short run flexibility for fiscal policy to operate as a counter-cyclical instrument. To that effect, two steps need to be taken: (1) defining long-run debt sustainability and short-run flexibility: (2) adopting a framework that supports this aim.

4.1. The Debt Sustainability Objective

Long-term debt sustainability requires that the debt level not increase as a percent of GDP. Where it is high, the objective is more demanding: the debt-to-GDP ratio ought to decline.

There is no clear definition of what is a reasonable public debt level.[9] The 60% Maastricht convergence criterion, for example, is an accident of history, the average debt level in Europe on the day the Maastricht Treaty was finalized. Is zero debt desirable? In principle, because taxes are distortionary, the lowest possible debt level allows to reduce the tax burden. In practice, there is no indication that the tax burden is lower where debt is smaller. In the OECD area, for instance, the partial correlation coefficient is negative (-0.03) and insignificant (t-statistics = 0.42).[10] Another view is that the government borrows on behalf of credit-constrained citizens, which implies that some positive debt level is welfare-enhancing. Similarly, with standards of living likely to continue to rise over the foreseeable future, intergenerational equity calls for some negative transfers to richer future generations.

The only reasonable conclusion is that a moderate debt level is desirable, but "moderate" cannot be precisely pinned down. We simply have to rely on good judgment. "Judgment" is the crucial word here. It means that human thinking, guided by clear principles, is a superior alternative to binding rules.

Long-run constraints are notoriously hard to enforce because of the time inconsistency problem: there will always exist circumstances where giving up a commitment is actually welfare improving, although as seen from the current perspective it is highly undesirable. The challenge, therefore, is to provide incentives for the authorities to abide by past commitments. Two main approaches are examined: rules and institutions.

4.2. Rules

Rules specify what is acceptable behavior. To be effective, they must include sanctions to be applied in the event of non-compliance. To be operative, the rules must be precisely set. Typically they are intangible, but they can be decided on a case by case basis.

Fiscal rules are on the rise. In a way, fiscal rules have been around for a long time: IMF programs typically include quantified fiscal objectives, with an explicit sanction in case of noncompliance, the suspension of the loan program. The Stability and Growth Pact is a prominent and innovative example of recently adopted fiscal rules. Like IMF programs, it is monitored and implemented externally, and it includes sanctions. It also sets quantified limits to budget deficits, but these limits are universal while the IMF decides on them on a case by case basis. Other recently-adopted fiscal rules also rely on quantified limits but, instead of sanctions, they simply make it illegal to breach the limits. Fines allow for some flexibility because they offer a tradeoff and can be "negotiated", while legal bounds are stricter. This is why legal bounds are typically made less strict by allowing an averaging over the length of a business cycle (the UK and Sweden), or by allowing for a cyclical adjustment (Switzerland). Doing so injects an important degree of imprecision (how to asses the timing of cycles or the allowed cyclical correction?), which may ultimately undermine the rule.

This brief description illustrates some important difficulties inherent to rules. First, explicit limits to deficits (or debts) must be specified. Because economic conditions change, these limits may become ill-chosen and prevent the short-run counter-cyclical use of fiscal policy. The solution is to allow for some flexibility. The IMF often renegotiates its programs. The GSP has recently faced a lenient political interpretation of the rule.[11] Averaging over, or accounting for, the cycle, is the most popular wayout but the implementation of this approach will be tricky given our poor ability to measure and foresee cycles, and to estimate the effects of cyclical fluctuations on the budget. The unavoidably large margin of error may prove to be the Achilles' heel of such rules.

Second these limits must be enforced. Experience with external enforcement by the IMF warns us that the political fallout may be lethal, and the experience so far with the GSP does not assuage such fears. Loan program suspension in the case of the IMF, and fines in the case of the GSP, only exacerbates the budgetary problem at the worst possible time.

Third, the main advantage of rules is that they appear as set in concrete. This implies that judgmental evaluation is ruled out. Yet, the desirability of policy action varies depending on time and circumstances. That rules are impervious to short-term expediency is their strength, but also their weakness. Judgment is superior if it can be relied upon.

4.3. Institutions

Institutions rely on the delegation mechanism: a principal entrusts an agent to deliver a particular task. The question is which agent, which task, and which control. In these respects, much has been learnt from the experience of central banks.

In both cases, the principal is the same – the people – except that monetary policy is vastly simpler than fiscal policy. Monetary policy deals mainly with macroeconomic issues, inflation, growth, employment, the exchange rate. Fiscal policy includes deeply redistributive functions that cannot be delegated to a single agent: all democratic countries delegate such choices to their parliamentary institutions which, by construction, embody the various diverging interests.

It is essential to realise that fiscal policy fulfills two very different tasks. The first task is structural and redistributive: the size and aims of various spending items and the structure of the tax system. Redistributive decisions cannot be delegated to an agent.

The second task is macroeconomic and is largely subsumed by the budget balance.[12] That task does not fundamentally differ from monetary policy and, to a first order of approximation, it can be designed independently from the first one. As such it can be delegated to an agent.

The key aspect of monetary policy is that the agent, the central bank, is given a clear constitutional mandate, and is made independent. These combined attributes sharply reduce the probability that the central bank will renege on its commitments. This feature make the agent (nearly) as good as a rule. The key advantage is that the agent can exercise judgment. Monetary rules have been largely discarded for that precise reason. Today's good central bankers deliver both long-run price stability and extensive short-run stabilization. This feature lies at the roots of other cases of delegation, such as anti-trust or financial regulation. There is no reason why it would not work for the macroeconomic aspect of fiscal policy making.

5. Rules-Based Fiscal Discipline

5.1. Fiscal Policy Committees

In each country, responsibility for setting the budget balance would be delegated to a new institution, the Fiscal Policy Committee (FPC).

Like the central banks' Monetary Policy Committees (MPC), the FPC would include a small number of qualified persons appointed for long, non-renewable terms of office. FPC members could not be removed from office unless they violate their mandates and they would not be allowed to seek or receive instructions from governments, members of parliaments or any outside person or group. The FPC would be supported by a staff that would produce its own forecasts of economic conditions and budgetary figures.

The FPC would given an explicit mandate, that of ensuring *debt sustainability* over the appropriate horizon. The specification of debt sustainability is presented in Section 5.2 below. Over the short run this would leave the FPC free to choose deficits and surpluses, as justified by its analysis of current and future conditions.

The power of the FPC would be limited to set annual deficit figures (say, in percent of planned GDP) ahead of the government budgetary cycle. Its decision would have the force of law, and impose itself on both the government and the parliament.[13] The FPC would have no authority regarding the size of the budget, the tax structure and the allocation of public spending. All these matters would remain as in the currently existing political process.

The budget bill, including spending and revenue projections, would require FPC approval before it becoming law. Any budget that does not comply with the FPC's balance decision would either be void – and would have to be redrawn – or, alternatively, would activate an automatic procedure to bring the budget in line. As an example of the latter, spending and/or tax revenues would be adjusted pro-rata.

In the event of abrupt change in f economic conditions, the FPC would mandate a change in the budget law. This could take the form of a new deficit figure, leaving again the government and the parliament with the task on adjusting spending and/or revenues. Eichengreen, Haussmann and von Hagen (1999) provide an excellent discussion of the relative merits of fixed review dates vs discretionary interventions.

Finally, exceptional circumstances – unforecastable, by definition – may warrant a suspension of the debt sustainability obligation. This is what lies behind the over-ride provision discussed in the case of monetary policy (see, e.g., Roll et al., 1993). Such a procedure must be exceptional: for instance, it could require a parliamentary vote with a super-majority.

5.2. The Debt Sustainability Mandate

Debt sustainability can be defined in two alternative ways:

- It can be an obligation to achieve budget balance on average over a number of years. The number of years should be of the same order as the length of ordinary business cycles (4 to 6 years). It should not be fixed *ex ante* since two cycles are never alike. A possibility is to delegate to another, independent institution – like the NBER in the US – the task of identifying cyclical peaks and troughs, and require *ex post* that the budget be at least balanced over each cycle.

- It can be an obligation to stabilize the debt-to-GDP ratio over the long-run, i.e. cycle after cycle. Countries which start with a high debt, or which face large future commitments (due to an ageing population, for example) could aim at a given reduction of the debt-to-GDP ratio over a given horizon tailored to the length of the business cycles.

Such an arrangement sets the incentives right. The authorities know *ex ante* that any budget relaxation will have to be clawed back in the not-too-distant future. As a result, they are likely to adopt a debt-increasing stance only if they think that it will be efficient, not only in the short run but intertemporally, i.e. if today's gains outweigh tomorrow's costs. Similarly, they will take advantage from favorable conditions to garner room for maneuver in anticipation of future adverse shocks.

An important aspect of these principles is that they eschew any numerical target for the debt level. As noted above, there is no optimal target level for public debts. Setting quantified targets inevitably elicits criticism, to which the response is to create an artificial "holly cow" which may be difficult to change later on. In addition, as made abundantly clear by the Maastricht convergence process, artificial targets can be easily flouted precisely because they lack a solid enough basis to be adhered to.[14]

5.3. Democratic Accountability

The present proposal may be seen as a technocratic encroachment on a fundamental aspect of democracy. This is not the case, for three distinct reasons.

Macro vs. microeconomics

The reason why fiscal policy is everywhere under direct parliamentary control is that it powerfully redistribute income. This aspect almost entirely originates in choices regarding the size of government, public spending programs and the structure of taxation. In contrast, budget deficits have a limited intra-temporal reallocation effect. They mostly redistribute income across generations, most of which are not yet in existence and play not part in democratic control.15 Democratic control is essential for deciding the size of government, the distribution of spending and the structure of taxation, but it has proven inefficient to set the size of the budget deficit. Taking the deficit and the debt out of the standard democratic process does not imply any loss of democratic control where it is fully justified. The macroeconomic aspect of fiscal policy is not different from that of monetary policy. In fact, the similarity between monetary policy and setting the budget deficit can serve as a guide to the procedure of democratic accountability to be applied to a FPC.[16]

Parliamentary oversight

The FPC would be accountable to a national elected body. The FPC will not be goalindependent, it will be instrument-independent, since the goal will be set either in its mandate (balanced budget over completed cycles) or by the government (debt target for the length of the legislature). Accountability requires both *ex ante* and *ex post* oversight.

- *Ex ante* oversight takes the form of regular testimony by the FPC President and the timely publications of the minutes of the FPC's policy setting meetings, including the votes of individual committee members, who could also be called to testify to the parliament. The FPC would be bound to publish its analysis, backed by all the technical material and data that may be used.

- *Ex post*, the FPC would be held accountable of its record. In the event that the goal is not achieved, the parliament could take a number of actions: a reprimand to the committee, or to some of its members on the basis of published minutes and votes; the dis-appointment of the FPC, or some of its members, in case of serious failure.

6. Compatibility with EMU Institutions

6.1. The Excessive Deficit Procedure

The Treaty of the European Union mandates each member of the Eurozone to subject itself to the Excessive Deficit Procedure whose aims are exactly the same as those considered here: long-term debt sustainability with some short-run flexibility to conduct counter-cyclical policies. The guiding principle is peer pressure and, if need be, peer-imposed sanctions. As noted above, this raises serious issues of accountability and sovereignty, and it injects a heavy dose of politics in an otherwise desirable undertaking. Setting up FPCs would deliver the goals of the Excessive Deficit Procedure without these important difficulties.

There would be no European-level FPC and the responsibility for enforcing fiscal discipline would be given back to the states. What would be required would be a change in the protocol that mandates the 3% and 60% limits. This section of the treaty would have to be replaced by provisions for establishing national FPCs which meet some common principles. This would follow the precedent set for national central bank statutes, which have to be compatible with the Statute of the ESCB (art. 109). Thus, each country would be requested to adopt statutes for its FPC that are compatible with agreed-upon norms: the objective (deficits, debts), the pre-eminence of FPC decisions in setting the deficit, and limits to deviations from the objective.[17]

A key advantage of this approach would be to restore an important element of sovereignty to national parliaments, along the principle of subsidiarity currently mistreated by the GSP. Far from increasing the technocratic level of the Union, joint FPCs would enhance the quality of national debates on fiscal policy by removing the "Brussels excuse".

6.2. Policy Coordination in EMU

The practice of policy coordination in EMU is currently perceived as unsettled. Some argue that there is no need for explicit coordination, others call for an "economic government of Europe". This is not the place to review in detail this debate, but a few observations are in order to examine how rule-based fiscal discipline would affect the situation.

Coordination covers two different aspects:

- *The aggregate policy stance and policy mix*. It is sometimes asserted that national governments ought to agree on an aggregate fiscal policy stance, both among themselves and with the ECB. The argument is that the policy mix affects the interest and exchange rate, and that the aggregate fiscal policy stance elicits reactions from the ECB. There is zero evidence that interest rates are affected by public borrowing, which is to be expected from globalized financial markets. The policy mix, on the other hand, is bound to affect the exchange rate but it is fair to say that our understanding, both theoretical and empirical, of this link is extremely limited. Attempts at influencing the exchange rate indirectly through monetary and/ or fiscal policies will fail in the future as they have failed in the past.

- *National fiscal stances*. National fiscal policies obviously spill-over from one country to another. This effect is obviously stronger for actions emanating from the large countries. The logic would seem to be that national fiscal policies would have to be coordinated, especially among the large countries. While correct in theory, the logic fails to account for two crucial facts. First, it seems politically impossible to subject national fiscal policies to foreign oversight. This objection is enhanced by the fact that fiscal policy is now the only macroeconomic tool available at the national level. Whatever the merits of coordination, they pale in comparison with the political need to keep a free hand at home. Second, it is equally politically unacceptable that large countries be treated differently from smaller ones.

It is fair to conclude that formal coordination of fiscal policies is unlikely to be agreed upon in the foreseeable future. Informal exchanges, on the other side, are highly desirable as they may help avoid the most grievous mistakes. Such an informal approach would be much easier to organize among independent, non-political FPCs than it currently is among Finance Ministers.

The coordination between national governments and the ECB has not been satisfactory so far, largely because the ECB insists on keeping governments at arm's length. Here again, it can be expected that the ECB will find it less threatening to entertain informal contacts with like-minded, independent FPCs.

6.3. Peer pressure in EMU

There is one area where some formal coordination would be required under rule-based fiscal discipline. It concerns the national determination of the goal set by the national authorities for deficits or debts. As noted above, the goal will have to differ from country to country and over time for each country. Obviously, one must make it sure that these definitions are compatible with the spirit of fiscal discipline. This calls for peer pressure.

The natural solution is to use the BEPG. Each country's goal would be the object of an evaluation. In fact, it is entirely possible to retain the SGP procedure and apply it to the goals set for national FPCs.

7. Conclusion: *Fix It or Change It?*

The GSP is proving difficult to implement. One approach is to look for ways to improving it. Another is to seek a different concept that allows to achieve the same aims. Delegating fiscal policy to independent experts opens the way to the institutional approach, which has proved successful in various areas where judgment is called for. The alternative to attempt to fix the GSP.

Much of current discussion looks to ways of making the GSP less asymmetric over the duration of a business cycles. The perception that underlies such efforts, fed by the unexpected turn of events over 2001, is that the automatic stabilizers ought to be allowed to run their full course when the economy is away from its potential GDP. Indeed, one weakness of the GSP is that it is based on commitments based on assumptions which can quickly be proven wrong. This perception leads to two logical "solutions".

The first idea is to apply the deficit ceiling to the cyclically-corrected budget. This is the approach recently adopted in Switzerland. Theoretically, this would go a long way towards allowing the automatic stabilizers to be fully utilized, even if the initial deficit is close to the ceiling. The devil lays in the details: how to measure the cyclicallycorrected budget? This requires estimating the potential GDP to determine the output

gap, and then estimating how the gap affects spending and tax receipts. A large literature has been devoted to this question and a number of cyclically-corrected measures have been produced. These measures are useful tools to form a judgment on fiscal policy stances, but they are far too imprecise to become the focus of a contractual arrangement with profound political ramifications.

The second idea is to evaluate fiscal performance over a completed business cycle, as in Australia, New Zealand and the UK, all of which mandate a budget balance target and/or a debt target. It is both theoretically sound and, in contrast with cyclical adjustments, implementable in practice. This is identical to the target suggested above for FPCs, the only difference being that there is no delegation to an independent panel. In the British case, for example, the incentive to abide by the fiscal code rests entirely on the transparency of the budget process and the belief that the government will not allow its credibility to be jeopardized by flouting its own rule. This may be a workable approach in some countries, but it is easy to see how the process can go wrong. First, the government can always invoke special circumstances and receive the Parliament's blessing. Second, the length of a legislature is unlikely to coincide with a completed cycle. This opens up the door to manipulation, for instance blaming the predecessor's legacy or letting deficits swell in the run up to an election. More fundamentally, it amounts to giving the jail's key to the convict: the main reason for seeking rules is the repeated observation that governments, supported by their parliamentary majorities, are prone to fiscal indiscipline.

Competent and dedicated policymakers are better able than quantitative ceilings and rules to exercise good judgment and deliver the adequate mix of restraint and flexibility. To do so, however, they must be shielded from the temptation and pressures that are part of political life. This is the approach that has been adopted for monetary policy by an increasing number of countries, so far successfully. Fiscal policy has not yet benefited from a similar treatment because of both traditions and the perception that fiscal policy belongs exclusively to he political sphere. Traditions too were once invoked to keep central banks under the thumb of politicians, but the recent changes show that traditions can be relatively easily shaken. The additional challenge for fiscal policy is the confusion between its structural and redistributive function, belongs to the political sphere, and its macroeconomic role, which can be delegated. There is no reason why FPCs should be less successful than the MPCs.

A major advantage of replacing the GSP with FPCs is that the subsidiarity principle would be applied where it should. With a common currency, national fiscal policy is more needed than ever. Many of the difficulties encountered so far by the GSP are directly related to a conflict with sovereignty, an additional instance when external enforcement of policy discipline fails.

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Notes

1 On reasons why governments may not be deeply committed to the common public good, see Buchanan and Tullock (1962), Drazen, 2000 and Persson and Tabellini (2000).

2 A well-known "0.5 rule of thumb", mostly derived from OECD estimates, asserts that for any 1 percentage point decline in GDP, the deficit increases by 0.5% of GDP (see Eichengreen and Wyplosz, 1993 and the review of the literature in Melitz, 2000). Melitz (2000), in line with Wyplosz (1999), finds instead a coefficient of 0.1-0.2. This may be an effect of the extension of the sample period to include the 1990s, an atypical period of low growth and closing down of the deficit to meet the Maastricht convergence criteria. It may also reflect the combination of the counter-cyclical automatic stabilizers, with an elasticity of 0.5, with discretionary pro-cyclical actions. Causality may be an important issue here as highly autocorrelated restrictive fiscal policies may have led to low growth during the 1990s. Most of the evidence is obtained through panel data estimation.

3 To account for lags, and to avoid the endogeneity problem, the lagged output gap could be used. The results thus obtained are not different from those presented here.

4 Following the political economic literature, e.g. Alesina and Perotti (1997), it would be desirable to add a number of political variables. The existing database, however, ends in 1995, which would preclude a meaningful study of the 1990s.

5 This stands in contrast to the view of the European Commission (Buti, 2001; Buti, Franco and Ongera, 1997) which claims that fiscal policy has turned procyclical in the 1990s and concludes that the Stability and Growth Pact will improve things by making fiscal policy at least neutral and possibly countercyclical when the automatic stabilizers are allowed to operate.

6 These flaws are not just bad luck or technological advances in banking. The unwritten yet ever wise Goodhart Law is that any measure that becomes subject to a rule soon changes behavior. This has been true for monetary aggregates and will also affect deficits or debts.

7 For a survey of the changing world of central banking, see Blinder et al. (2001).

8 See von Hagen and Harden (1994).

9 See Perotti et al. (1998) for a discussion of sustainability as well as for useful references. They consider fiscal policy to be sustainable when there is no need for sharp adjustments. These authors conclude that, because sustainability cannot be appropriately defined and measured, attention should shift to controllability. In a sense, this is the view adopted here too, as the focus shifts to institutions which are likely to deliver a debt that remains under control, independently of its size.

10 It can be objected that the three Scandinavian countries and Japan are outliers. Without these four countries, the partial correlation coefficient is positive (0.13) and significant (t-statistics = 2.27), but it is not clear why these countries should be excluded. The Scandinavian countries

illustrate the main point that a low debt level may be intentionally accompanied by a large tax burden, while Japan shows that small governments can run unsustainable fiscal policies.

11 The escape clause – a deep recession – is far too restrictive to be of practical use, see Eichengreen and Wyplosz (1974).

12 The macroeconomic effects of spending items and taxes differ, but these differences can be safely taken as second order of magnitude.

13 A step in this direction has been adopted in Italy in the early 1990s. The deficit is decided by the government in the summer, and it takes the form a law. When the rest of the budget (size, spending, taxation) is set by the government and discussed by the parliament in the fall, the budget law cannot be modified anymore. von Hagen and Harden (1994) convincingly argue that this step has been crucial in Italy's successful efforts at stabilizing and reducing its public debt. Another related development is the increased power of the Belgian High Council for Finances which can issue recommendations regarding the size of deficits at the federal and sub-federal levels, see von Hagen (2001).

14 A common problem with quantified constraints, which also applies to balanced-budget laws, is that they can be escaped through creative accounting, including off-budget spending or the creation of separate government agencies exempt from the constraints, see von Hagen (1992).

15 It could even be argued that the current generation is ill-suitedto provide a fair treatment of future generations.

16 As I was formulating the present proposal I came upon a nearly identical one by Eichengreen, Hausmann and von Hagen (1999). They go in considerably more details regarding the design and functioning of their proposed National Fiscal Councils.

17 High-debt countries need to have different goals from low-debt countries. Furthermore, over time, the goal may change in any particular country. This implies that the treaty only need to specify the nature of the objective – debt or deficit – and allow each country to specify the goal.

DISCUSSANTS

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Discussants:

A) PROFESSOR RAY BARRELL

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The paper by Charles Wyplosz reflects and expands on issues that many of us in the UK have been talking about and worry about in relation with the UK government's position because we are outside the monetary union. My comments will be parochial not just because I am British but because I wish to discuss issues which are relevant to lot of people here, but there are many things to learn from European experience.

Why the stability pack was set up and what was it trying to do?

In 1990 the Maastricht Treaty was discussed and then signed a couple of years later. The idea of having a debt target was actually very clear in that discussion. The 60% debt target was part of the initial rules on the formation of the monetary union. At that time it seemed sensible to be aiming at getting debt within 60% of GDP and in order to achieve and sustain this the deficit really should not be over 3% of GDP. The 1990's turned out to be rather more difficult than many people expected. It is always easy to say that we should loosen our fiscal policy and it is always difficult to say that we are tightening our fiscal policy. It is very easy to say "good Lord make me good but not yet'[1]. There is a problem with fiscal policy as with other borrowing. Everybody knows that in the future they will be solvent when they are old, but when they are young they are not keen to be on the path to solvency. It is a structural problem of incentive compatibility over time that is common for all individuals. Debts and deficits were higher than had been anticipated and towards the end of the 1990's there was discussion of

[1] St Augustin should here be rephrased as "Lord make me solvent but not yet"

a new treaty to set up monetary union. The discussions around the new Treaty were not public, but many people will have thought they had to set up a set of rules which would keep the Italians and high deficit southern Europeans others out of the first wave of EMU. Therefore they agreed on 3% deficit as they thought it would not be achievable. The target of 3% had no foundation either in economic theory or in economic sense. It was a number chosen for political not economic convenience. However, the Commission and all the other people involved had to set up a very complicated treaty where there were rules and numbers (it is very rare to see numbers in a treaty except when they are reparations involved). The set up of the second treaty was very much a political fudge. It is very unfortunate setting up a set of institutions for the medium term on a political fudge because it is very difficult to rebuild institutions. It would have been nice if we had put more thought into it and if the UK had been part of the discussion.

Fiscal Policy in the UK

The UK has in the last few years has some serious problem with fiscal policy. The government has said "we will increased spending because we must have better hospitals, better roads and better education", and nothing has happened. The government did not manage to spend the money it said it was going to spend. In the mid 1990's, the UK followed an increasing trend and a very wise one of decentralising parts of government policy to agency and ministries. We have now a system of public finances in the UK where an agency or a ministry is given a budget for three years, so output targets and it has the right to decide how to achieve those targets. It can employ capital or labour in the combinations it wants, at time it wants. So the government can say "we want to invest more" if every hospitals trust but we do not need to invest any more no public investment comes forward". It is a wise move but make fiscal policy more difficult because what happens is now becomes a macroeconomic decision, very wise. There is another thing we have to think of in setting up fiscal policy rules: there is a very strong case, especially for income tax, for setting an announced and constant tax rate over the foreseeable future to be revised only if they are very strong reasons for doing so. (proposition of John Flemming). Very wise as a maximisation proposition so if we decide it is wise for macro reasons to get rid of the ability of the government to spend more money (apart in medium term), we get rid of the government's ability to change tax rate for macroeconomic purposes. Then we are beginning to reduce the number of fiscal instruments. The Golden rule we use in the UK as a macro economic idea: if the government decides to invest in order to produce services for individuals in the future, there is a good case for it borrowing in the capital market in order for the price of capital is right and the transformation costs and transformation consumption are right. There is a macro reason for the Golden rule which is older than the German constitutional reason. The Dutch's constitutional reason would have it from the 1920's. We can fin the Golden rule in "Pigou" (?) for instance. What we want the government to do is to be very efficient. Macro policy is on top. We still have to have fiscal rule because it is very useful for the government to say "we are committed to be fiscally sensible. The budget deficit and the debt stroke will not get out of hand. We therefore set ourselves out target, people can make decisions in relation to that and therefore we should find better informed decision, lower interest rate, lower inflation expectation". In the UK, we try to do that. We do not have a monetary policy committee which is independent but different from the UCB: the Chancellor sets the inflation target and appoints the people and it is not always clear what it is going to do because it is a committee by consent but by vote. It is problematic. The other UK institution, the fiscal rule system is very nice: it says: "we will run a deficit or surplus but we will only borrow to invest over the cycle but we might borrow less that we invest over the cycle." You need to define the cycle to make it an operable rule. The government can define the cycle in its budget projections but that is to a very large extent arbitrary: define a business cycle and when it ends is very hard indeed. If we to change the European system, we should move away from the year to year targets, we should not move to a cyclely adjusted budget deficit year by year. We have to also avoid governments announcing what the cyclely adjusted budget is, and also when the cycle ends. We are proposing that we set up an independent fiscal authority that determines when the cycle ends.

It is very hard to define a good system especially of the sort where the fiscal policy committee just says what the deficit should be. Look at Portugal in the last 2 or 3 years. Portugal was saying "we have a deficit of 2.2% of GDP this year. They did their national accounts and re-fiddled some numbers and found out that their deficit was over 4% of GDB last year, heading to 5% this year. Numbers get revised so much that it is a very difficult task for the independent authority to produce a forecast of next year deficit which can impinge on government actions even if the government is forced to act on it, that deficit target can be as unwise as any other fiscal policy.

I think we need fiscal rules. I think keeping debts stocks within boundaries is absolutely vital. Designing a system which makes debts in bit-debted countries is very wise. Those have to be the essence of a fiscal structure we move to. Setting also an institution is also wise. I am sure that the British parliament would accept a fiscal policy committee for the UK because it takes away its independence to fiddle with things. But some sort of medium term fiscal framework has also been attempted in Britain which has some better elements than the European system. It has strong macro-foundation in it, some borrowing to invest is permitted, there is some idea of decentralisation of decision making to increase efficiency and there is some commitment to keep tax rate constant except perhaps in direct tax rate because all the constraints we have previously really left that fiscal policy committee with the right to tell the government effectively to change the indirect tax rate.

Fiscal policy has been shown to be very bad at fine tuning. Most of the movement in the government budget deficit has nothing to do with the business cycle. It is pure random noise. But it is vital in any fiscal policy committee structure has to keep their fiscal policy when it is needed. When we move to a 1929-1930 Depression, the fiscal policy committee's job is to prevent that happening first, not last. The budget constraint and even the debt constraint, I would argue, have to be left for the fundamental use of fiscal policy to stop big depressions. If we cannot stop depression, some 70 years later after Keynes, we have not learned very much.

B) PROFESSOR GIORGIO BASEVI

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There are two aspects in the proposal to modify the Stability and Growth Pact (SGP) that Charles Wyplosz has presented to us tonight. One is related to the very content of the proposal, the other to the likelihood that the SGP will indeed be modified.

Let me consider first the content of Wyplosz's proposal. I agree with him that there is a wide consensus among economists on the need to modify the SGP. His emphasis is on the need to change the main SGP target from the public budget constraint to the sustainability of the debt in the long run.

In Wyplosz's opinion, proposals to modify the SGP budget constraint by referring to cyclically adjusted budgets are likely to raise problems, as the measurement of the effects of the cycle on the budget can easily be played with. In fact, there is fuzziness in the definition of the cycle; therefore it is better, according to Wyplosz, to consider a clearer long term reference, such as the sustainability of government debt.

In my opinion, the problem that Wyplosz thus tries to push out of the door, comes back from the window. In fact the practical difficulties in measuring the sustainability of the debt are no less, possibly greater than those encountered in measuring cyclically adjusted budgets.

Wyplosz's formulas contain four elements: future government expenditures, future taxes, rate of interest, and rate of growth of productivity. The difficulty in making forecasts and evaluating these four variables, make it very debatable any measurement of the long term sustainability of the debt.

Moreover, just like in the case of the budget, also the measurement of the debt is prone to attempts at "creative accounting". Recently, major EU countries, including Italy, have used creative accounting to this purpose, with criticism on the part of the EU Statistical Office and the EU Commission.

The other aspect of Wyplosz's proposal relates to the likelihood that the SGP will indeed be modified. The problem is to imagine how this could come about. While the EU Commission has already made some proposals to the EU Council, they do not go, in my opinion, far enough. My expectation is that the main trust for change will not come from the EU Commission or the EU Council –where opposed country interests tend to cancel out—but from the European Central Bank, although in a soft and indirect way. In fact, if the member countries were to strictly follow the rules of the SGP, they will, in a downfall, provoke more deflation than necessary. By so doing, political pressure builds up on the ECB to adopt an unduly relaxed monetary policy.

Thus the ECB should be wary of a situation in which the SGP is strictly followed, because this will induce the politicians to ask for a more expansive monetary policy. Until now the ECB has on the whole stayed out of the discussion on the need to revise the SGP. My opinion is that, if the ECB could influence the discussion of the SGP, it should influence it in the direction of a more relaxed ruling of the pact, because otherwise the Bank itself would be driven continuously into the political arena.

I also have an alternative view of the problems surrounding the SGP. In my view, in addition to trying to change the terms of the pact, we should move towards an aggregate view of the deficits and debts of the participating countries. The problem to which the SGP addresses itself is due to the externalities that the deficits of each participating country provoke on the others through changes in the interest rate, which is common to the group. While the SGP imposes on each participant an individual constraint, what matters is the overall Euroland budget and the overall Euroland government debt. It has been rightly pointed out that the problem is not dissimilar to the one of pollution, which can efficiently be met by issuing permits to pollute. If individual countries deficits damage other countries, there could be a market for permits to run excessive deficits, just like there are markets for polluting permits.[2] This approach to the problem may seem theoretical, but it indicates the point that it is necessary to take an overall view of the deficit for the group of member countries, and try share it cooperatively or through market mechanisms.

A similar proposal is to take an aggregate view of European government debt. Commissioner de Silguy launched the idea of an European Government Debt Agency,[3] but it was put aside for political reasons. Now the idea may be mature, as there is a market failure to be corrected. The liquidity of the debt of Germany is higher than the liquidity of the debt of Portugal, simply because of their different sizes. If the debts of the various countries' governments were pooled, we would get a wider market, a more efficient one with a lower liquidity premium: there is an efficiency gain to be reaped for all.

In conclusion, I think we should go beyond the SGP and look into Wyplosz's proposal to create new institutions for controlling the budget deficit in each country. In addition to his suggestions, I submit that there should be a renewed discussion of the possibility to create an

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[2] See Alessandra Casella, "Tradable Deficit Permits: Efficient Implementation of the Stability Pact in the European Monetary Union", Economic Policy, October 1999, pp. 323-64.

[3] EU Commissioner Yves T. de Silguy made the proposal in a speech to the Corporation of London in July 1999. For a more worked out analysis, see "Co-ordinated Public Debt Issuance in the Euro Area, Report of the Giovannini Group", 8 November, 2000, available in internet at the address:
http://europa.eu.int/comm/internal_market/en/finances/general/

European Government Debt Agency to pool, and more efficiently manage, the European Governments debts.

C) PROFESSOR DAVID VINES

Professor of Economics, University of Oxford

Charles highlighted the conflict between two things. On the one hand there is a long run need for fiscal sustainability, which pushes towards rigidity and fiscal constraint, and the imposition of a discipline external to the policy process. On the other hand there is a need for short term flexibility, freedom, autonomy, to deal with national problems. The Stability and Growth Pact involves a rigidity - the prevention of pursuit of the second objective as a result of enforcing the first objective. Charles' aim is to find a better way of enforcing long term stability that does not stop short term flexibility.

This could be a discussion about one individual country, as well as a discussion of the European Union. But we should note three differences between a country and the EU.

First, in the European Union, there is a difficulty imposed by having a single monetary policy with a common authority, and fiscal authorities wishing to take separate decisions in their pursuit of short term flexibility. Notice how easy this can be for a country. It can decide what its debt target ought to be at the national level, and if it can then impose this by politics on the subsidiary states in the country. In Australia for example, there is a preponderance of revenue going to the central government. That government determines what the state can do fiscally, as the condition for their getting the revenues that they need in order to carry out their spending plans That is very different from the fiscal position in Europe. Argentina could not do this, and as a result Argentina paid. Europe must avoid that problem - the long term fiscal solvency issue is important.

Second, for an individual country, most shocks are stabilised by monetary policy. Monetary policy makers can follow counter-cyclical management, as well as their long-term objective of stabilising their price level, and are now generally able to do this well, as for example in for example in the US and the UK. And if there are local shocks, federal politics and federal institutions can lend, or give, money to the regional state levels in a way that is not possible at the European level.

Third, it is easier in a nation for another reason. When changes are needed, these can be organised by national politics. Again to take Australia, in the late 1980's it was decided that, facing a large current account deficit, the country needed to more. The policy response had two features - fiscal tightening and monetary loosening - both organised within the one political process. Thus, once a country has something like a long run debt target, in the way like Charles describes, then both instituting it politically and managing flexibility within it is a reasonably straight forward matter. Suppose that Europe said: "we face a looming pension problem, we need to save more". What happened in Australia when the decision to save more was taken was that both fiscal tightness and monetary looseness emerged. How can that be organised, Europe wide? If you are not going to do it Europe wide, what are the incentives to do it in the individual country? The Central Bank will not be loosening policy and so there will be costs to individual countries of fiscal tightening. Thus with monetary integration we need cooperation on the construction of a fiscal policy across European regions.

Charles' solution is that when you go to a Monetary Union, there should not be something like the Stability and Growth Pact, but instead debt targets. There should be an attempt to enable these targets to differ across countries, according to their current savings position and long run savings needs. This would ensure long run solvency. Then in the short run, separate countries can deliver management of shocks which occur asymmetrically in their particular regions. This would help significantly in dealing with the German problem which Charles described.

The difficulties of working well in the union are greater if the ECB is not working well. What we are seeing at the moment is a move towards fiscal loosening in the face of a downturn, and this is arising in part because the fiscal authorities in the 12 separate countries do not trust the monetary authority to manage the cycle. This can turn into a difficult political game if the central bank turns around and says: "We are not managing the downturn precisely because we want the fiscal authorities to be more contractionary." The outcome then can be that the monetary authority does not stabilise and the fiscal authorities are forced into the position of doing things in the pursuit of stabilisation which may in the medium term endanger pursuit of the debt target and so endanger financial stability. A well functioning EMU will require not just better fiscal outcomes authority can do but also more clarity on what the monetary authority should be doing as well.

Fundamentally, I agree with Charles. He pushes us in the right direction. To solve the problems which he describes requires not just a process better technical management: as when creating an independent Central Bank we need both long term stability and short term flexible management, and there are technical requirements for doing this well. But we also need much greater degree of political cooperation amongst the member states in the conduct of fiscal policy, and cooperation between fiscal policy and monetary policy.

ADDITIONAL QUESTIONS:

On monetary and fiscal policy.

There is one big difference: you may have a single monetary policy authority but you may have in one country a multiplicity of fiscal authorities and further more, which is an interesting point, they may be engaged in vary complicated political games so they may not all pull in the same direction. It may even be that some of the fiscal authorities say in the German Länder and the Swiss Cantons are governed by a different party than the central government is and they therefore have different interest in the policy they are pursuing. Do you think that lessons can be drawn, nevertheless?

It also sounded as if independent fiscal panels could become an ‘exportocracy’. What do you thing that would do to the public acceptance of policy, which we know has been plummeting in many countries anyway? Taking away this questionable power from Government even more than has been done through the processes of economic integration, would you think that it would be acceptable to the wider public?

REJOINDER:

PROFESSOR CHARLES WYPLOSZ

First, a reaction to Burrel: I found very interesting the description of how to try to build a more efficient and more responsible government in the UK. You are introducing ever longer run principles that cheap away at the possibility of running fiscal policy. So far you have a monetary policy and a central bank but that may not last when things become harder. Fiscal policy may misfire first because it is politically motivated. Second, people often talk about the l the fact that it takes so long to get through the whole process so, by the time fiscal policy actions hit the floor, the economy has turned around. One of the arguments in my list of pros is that an independent fiscal policy authority can move much faster.

One of the reasons for the lack of fiscal policy activism today is that governments have to negotiate internally who will do what. Then they have to go to parliament and negotiate, and the parliament is going to take its time, so by the time this whole process comes to a close, 6 months, if not a year, has gone by. In my model, the fiscal policy committee would have the right, in face of an unexpected situation, to mandate a change in the budget deficit. This would also help with the bad reputation of fiscal policy.

We would all like to tailor fiscal policy objectives to business cycle length. The problem is that business cycles are very different in length so we cannot foresee business cycles. The debt target ought to cover a complete business cycle. We would need independent experts – e.g. market observers, academic economists – to determine the cyclical position and can estimate whether fiscal policy misses its long term target. Such an arrangement would force the committee to be very prudent in its deficit decisions. They would know that their judgement will be subject to scrutiny. Another solution is to a adopt long target, say 6-7 years, but this can raise political difficulties since the debt target may be set for a horizon which lies beyond the length of the government's term.

Would the British parliament accept to give up the bank of England for the European Central Bank? Maybe.

On the issue of coordination and the link between the ECB and the fiscal authorities, I share Basevi's two statements. It is dangerous for the ECB, which claim that it is not to listen to governments, and is completely protected from government instructions to start giving instructions to government.

One of the problems we currently face in the monetary union is that the ECB explicitly does not to engage into coordination discussions with governments because they want to protect their independence. They say that they cannot be fully independent if they are seen as talking with the governments. I think this is a childish approach. If we were to go in my direction where we have expert fiscal policy committees, negotiations would be much easier. It would facilitate policy coordination between monetary and fiscal authorities in Europe.

For me the fiscal policy committees would not be a six or seven ladies and gentlemen sitting in an ivory tower. They would be institutions like the European Central Bank, complete with a staff, very carefully monitoring the budget, with the right to censor the government.

Finally, the point about bureaucracy and public acceptance. It is interesting in the Eurobarometer Polls which ask every six months which policy-making institutions , (the ECB, national governments and the European Commissioner), enjoy better public trust, systematically, the ECB comes ahead of the European Commission, and the European Commission comes ahead of national governments. So much for the fear of invading bureaucracies!

The Europaeum Record

I. Academic Conferences

1993 Oxford: *Are European Elites Losing Touch with their Peoples?*

1994 Oxford: *Europe and America after the Cold War: the end of the West*

1995 Bonn: *The Integration of East Central Europe into the European Union*

1996 Geneva: *Defining the Projecting Europe's Identity: Issues and Trade-Offs* at Geneva

1997 Paris I: *Europe and Money*

1998 Leiden: *Human rights, with particular reference to plight of immigrants and immigration policy in Europe*

2000 Bonn: *The Implications of the new Knowledge and Technology* at Bonn

2001 Berlin: European Universities: *Borderless Education: Challenges for the new Europe*

2002 Paris: European Universities: *New Times: New Responsibilities*

2003 Bonn: European Universities: *New Partnerships: Opportunities and Risks*

II. Student Summer Schools

1994 Leiden: *Concepts of Europe*

1995 Bologna: *The Problem of Political leadership between History and Social Science*

1996 Bologna: *The Civic Nation and the Ethnic Nation*

1998 Budapest: *Risk Policy Analysis*

1998 Oxford: *Human Rights*

1999 Paris I: *NATO and European Defence*

2000 Bologna: *European Policy and Enlargement*

2000 Oxford: *Church as Politeia: the political self-understanding of Christianity*

2001 Oxford:	*Human Rights and the movement of people: Meeting the Challenges of Racism, Migration and Displacement*
2002 Oxford:	*The Economics of European Integration*
2003 Prague:	*Old and New Ideas of Federalism*

III. Joint Teaching Courses and Programmes

1992 - Oxford	*European Law* involving joint teaching and study, and student exchanges linking Oxford, Leiden and Sienna.
1999 - Paris	*Economics of European Integration* module open to Europaeum undergraduates and graduates.
1999 Bologna	*Political Cultures and European Political Systems* joint programme linking Bologna to Oxford and Leiden.
2000 Geneva	*International Refugee Law* joint teaching Programme linking Geneva and Oxford.
2003 Leiden	*Leadership Programme* in *European Business, Cultures, and Institutions linking Leiden and Oxford.*
2003 Bologna	MA in *European Political Cultures, Institutions and History linking Bologna, Leiden and Oxford.*

❑ Cross-Europe academic networks function in Economics, History, Politics and Theology, helping to promote collaborative teaching and mobility of graduate research students. Other initiatives link scholars in Classics, History of Science and Environmental Science.

❑ The Europaeum played the key role in the creation at Oxford of the *Centre for European Politics, Economics and Society, the Oxford Institute of European* and *Comparative Law*, plus a number of fellowships, the *Chair in European Thought* and, most recently, the *Bertelsmann Europaeum Visiting Professorship in 20th Century Jewish History and Politics*.

IV. Scholarship Programmes

❑ The **Oxford-Geneva Link Programme** provides annual bursaries for student exchanges between Oxford and the Graduate Institute of International Studies, together with other collaborative activities including joint teaching and Europaeum Lectures.

❑ The **Europaeum Scholarships in Jewish Studies** have provided up to six places each year for Europaeum graduate students to spend a year in Oxford studying for the Diploma in Jewish Studies at the Oxford Centre for Hebrew and Jewish Studies between 1995 and 2001. Discussions continue to create a new scheme to accompany the upgrading of the Jewish Studies programme to an MA course.

❑ The **Scatcherd European Scholarships** scheme, founded at Oxford, as part of the Europaeum initiative in 1997, offers fully funded places at Oxford for European graduates, including all Europaeum partner institutions; and also places for Oxford graduates at leading European Universities, including Europaeum partner universities.

V. Joint Research Projects and Support

❑ A **Research Directory** of interests of staff involved in European Studies in partner institutions is accessible via the Europaeum internet site to build and encourage academic collaboration.

❑ The **Europaeum Project on the *Future of European Universities***, supported by DaimlerChrysler Services A G, a three-year investigation into the impact of new technology and the Knowledge Revolution was initiated in 2001. International conferences on *Borderless Education: Bridging Europe* (Berlin 2001); *New Times New Responsibilities* (Paris 2002); and *New Partnerships: Opportunities and Risks* (Bonn 2003) have been held.

❑ The ***Europaeum Research Project Groups*** scheme encourages collaborative research across the association. The following groups have been backed so far: The Churches and the Family; European Monetary Integration; The Kosovo Stability Pact; International Intervention; European identity; Unilateral Action; Regulation of E-commerce; Liberalism in 20th Century Europe; Transmission and Understanding in the Sciences; and Cultural Difference in Europe.

❑ Past international **Europaeum research projects** have been on *Party System Changes* (1997) and *The origins and aftermath of the Kosovo crisis* (2000).

VI. Mobility Schemes

❑ The ***Europaeum New Initiatives Scheme*** provides seed funding for new, innovative and imaginative forms of academic collaboration within, but not exclusive to, the Europaeum academic community.

More than 20 projects have been supported including Staff Exchanges on e-commerce; a Theology summer lecture series; Anglo-Czech Historians Project; Classicists Colloquiums; Third Way Conference, Russia and Europe and Model European Student debates; EU Policy Transfer Seminar and inquiries into the Church and Family; and transmission of science ideas.

❑ The ***Europaeum Visiting Professors Scheme*** supports the movement of academics from one partner institution to another.

❑ **Europaeum Mobility Schemes** aim to support individual academics and students from member institutions participating in selected European events and activities, including conferences, seminars and summer schools.

The Europaeum
Partners & Representatives

❑ OXFORD

The University of Oxford, comprising 39 Colleges and 6 Private Halls, dates its foundation offically to 1249, though teaching at Oxford is known to date back to 1096, the first overseas scholar having arrived in 1190.

Vice-Chancellor: Sir Colin Lucas

Academic Committee: Professor Michael Freeden (Politics)
Professor Robert Evans (History)

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❑ LEIDEN

Universiteit Leiden founded in 1575 by the States of Holland, as a reward for the town's brave resistance against the Spanish, at the behest of William of Orange.

Rector: Professor Douwe D Breimer

Academic Committee: Professor Henk Dekker (Politics)

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❑ BOLOGNA

Università degli studi di Bologna officially constituted in 1158 by Emperor Frederick I Barbarossa, though independent teaching dates back to 1088.

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❑ BONN

Rheinische Friedrich-Wilhelms-Universität Bonn founded in 1818 by Kaiser Friedrich Wilhelm III, preceded by an Academy established in 1777.

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❑ GENEVA

The Graduate Institute of International Studies founded in 1927, associated to, but not part of, the University of Geneva.

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❑ PARIS

Université Paris I Panthéon-Sorbonne founded in the 12th Century, and formally constituted by Papal Bull in 1215, was briefly suppressed by the French Revolution between 1793 and 1808, and reconstituted in 1890.

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❑ PRAGUE

Charles University, Prague, founded in 1348, was divided into Czech and German institutions by the Vienna government in 1882. These operated in parallel until 1939, when the Czech institution was closed by Nazi occupation. After 1945, the German institution was abolished and the Czech Charles University revived.

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❑ MADRID

The Complutense University of Madrid, one of the oldest and largest in the world, was founded in 1293, originally in Alcalá de Henares, moving to Madrid in 1836. It has about 100,000 students, including 3,500 international students.

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Je vois avec plaisir qu'il se forme dans l'Europe une république immense d'espirts cultivés. La lumière se communique de tous les côtés.

VOLTAIRE
in a letter to Prince Dmitri Alekseevitch Golitsyn
14 August 1767

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