Europe's economic institutions: Stability- or growth-oriented? [*]

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Abstract. The paper deals with various aspects of the performance, especially from a macroeconomic point of view, expected from some of the most relevant European institutions (monetary and tax authorities, unions) *vis-à-vis* alternative ones. The role of the rules (e.g. the Stability and Growth Pact) as a coordination device to deal with externalities arising from national fiscal policies is first considered and compared to explicit coordination. The priority given to price stability is then discussed together with the questions of reputation, credibility and the relationship with fiscal policy and labour markets. A conservative central bank eliminates the temptation to inflate, but is only a second-best solution for internalizing the externalities arising from uncoordinated-wage bargaining. The paper finally discusses the consequences on growth of the stability pursued by actual European institutions. Some reflections on the 'model' adopted for shaping European institutions conclude the paper.

1. Introduction.

The time has come to assess the appropriateness of European economic institutions.[1] As the EU consolidates and enlarges, the role of institutions inherited from the past tends to diminish and the performance of those built in the 1990s can be properly evaluated. We are in effect at a time when reflections of a constitutional nature are in order.

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[1] By institutions we mean both rules of interaction among people (or countries), such as – in our case – the Stability and Growth Pact, and organisations, like the European Central Bank.

The need for (re)considering the appropriateness of Europe's institutions is particularly acute from the point of view of their influence on long-run performance, if one accepts the position that institutions matter for growth (Acemoglu *et al*, 2004).[2]

Some of the main EU institutions explicitly pretend to have been forged in view of obtaining stability and growth. As a matter of fact, they tend to pursue much of stability, little of growth. At best they fight the battles of the ‘90s, not those of the new decade.

In 2000 the European Council of Lisbon decided to set a new strategic goal for the next decade, i.e. ‘to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion.’ It is obvious that in order to achieve this goal both economic and social action is required. The set of initiatives of the European Union in the economic and social fields in order to reach the above goal is commonly known as the ‘Lisbon strategy.’

The ambitious target set in Lisbon for European innovation is in sharp contrast with the reality of the starting point as well as with the evolution of the European economy since the time when the strategy was devised.

Making Europe the most innovative country in the world has two specific implications. It implies first that the goal of catching up with the United States technology – and then the role for Europe of imitating the latter – should be superseded by true innovation. Its second implication is that Europe should build institutions consistent with innovation (Aghion, 2004) rather than with imitation.

The issue of consistency between the Lisbon goals and existing European institutions is the main focus of this paper. For historical reasons many European institutions – in particular, the EMU and the *Stability and Growth Pact* (SGP) – were forged not to foster growth but to prevent economic instability. There were many justifications for such a choice at the time they were devised. First of all, the conventional economic wisdom of the late 1980s argued in favour of neutrality of expected money, time inconsistency, and superior performance of countries having independent central banks. Second, the public opinion put a weight on combating inflation higher than that assigned to reducing unemployment (for both these remarks see Wyplosz, 1999). In addition, the European countries, in the process of their unification, started each with very different initial conditions and modes of conducting public policy. Some of them (like Italy) were really at risk of instability. Before integrating with

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[2] As North and Thomas (1973) put it, the other elements that have been listed – such as factor accumulation and innovation – are not causes of growth; they are growth. By contrast, according to these authors, differences in

these some other countries (like Germany) asked at least for some assurance that they would not 'import' instability.

As the main target of the European economy is now shifting from stability to growth, the role of institutions and policies more suitable for the new goal has to be emphasised to the detriment – if a trade-off arises – of those designed for economic stability.

There are a number of growth-friendly policies. They are both microeconomic (e.g., assigning property rights to foster innovation; establishing well-working financial markets as instruments for directing resources to growing sectors and the efficient conduct of enterprises, introducing social protection as an institution favouring risk-undertaking, education, mobility, flexibility) and macroeconomic. However, in this paper we analyse almost exclusively institutions administering macroeconomic policies in three specific areas, monetary policy, fiscal policy and wage setting, disregarding issues referred to the international setting of the EU. By their nature macroeconomic policies do not have a direct role in favouring innovation, but only an accommodating and accompanying one. This role can be in contrast with the role they can be – and have actually been - attributed of ensuring economic stability.

The conservative central bank is the first such institution. The traditional argument for it is the need to avoid the negative consequences of lax fiscal policies on inflation and unemployment in a world dominated by forward-looking expectations. To directly tackle the issue of fiscal policy profligacy some limitations to the action of governments can also be imposed and this has taken the form of the SGP, which can be seen as an alternative to the conservative central banker. The conservative central banker is also deemed to be able to cope with institution failures in the realm of the labour market. With decentralised labour setting, in fact, a conservative central banker can guarantee a better performance.

We can assess the appropriateness of these institutions for the purpose for which they had been devised, i.e. stability. We will also explore the possibility to find an alternative set of institutions performing the same or even a better task, possibly not in contrast and more in line with growth. More specifically, we will see whether there is an excess of institutions pursuing price stability and determining an unemployment bias that can be of detriment for growth.

In section 2 we consider the various tests for assessing the appropriateness of institutions. In sections 3 to 7 we analyse the various existing institutions – EMU entry requirements and the SGP; the European Central Bank (ECB) and its relationship with fiscal

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institutions are the real determinants of comparative growth.

authorities; labour market institutions also in their interactions with monetary and fiscal policies – mainly from the point of view of counter-cyclical action. Section 8 deals with the issue of complementarity or substitutability between the objectives of stability and growth. Section 9 is devoted to the analysis of the proper institutions for fostering growth. Section 10 concludes.

2. Various tests for institutions.

The analysis of institutions takes a central role in economic policy discussions. Each institution and the assortment of various institutions should be analysed with a view at the following issues: their efficiency and consistency; the expected performance (in terms of the objectives pursued); their transparency and accountability.

A first relevant aspect of institutions is their capacity to pursue some goal in an efficient way. When there are many institutions, an important element of their effectiveness is given by their capacity as a whole to reach some goal in a more efficient way than any other alternative combination of institutions. We will refer to this requirement as 'consistency.'

Consistency is of the utmost importance when there are trade-offs among different targets and problems of co-ordination. By definition a monetary union is a highly integrated economic area with a large number of interactions between the different institutions. Given the presence of macroeconomic positive and negative externalities, the design of economic institutions is a crucial issue, but the optimal policy mix of different institutions and their optimal coordination are not a trivial outcome to obtain.

One of the main aims of this paper is exactly to discuss the implications of the simultaneous existence of several problems of coordination:

a) coordination between fiscal policies of different countries;
b) coordination between monetary and fiscal policies for stabilisation purposes;
c) coordination between monetary and fiscal action for stabilisation purposes and microeconomic policies for growth;
d) coordination between these policies and wage setting;
e) coordination between wage setting in different countries.

Many such problems have been studied separately until now and some of them (e.g. those under c) and d)) have almost been neglected.[3] Failure to recognize the existence of different kinds of coordination problems has prompted the formulation of incorrect and/or politically-biased policy recommendations. For instance, central bank conservativeness has recently been suggested as a possible solution for the negative externalities arising in a non-coordinated wage setting (see, e.g., Beetsma and Bovenberg, 1998; Coricelli *et al*., 2001, 2002). However, once the existence of different problems of coordination is recognized, the conservative central banker's solution is a poor substitute for other types of coordination in internalizing negative and positive macroeconomic externalities arising from the lack of coordination (Acocella *et al*, 2004a and 2004b).

Consistency says nothing on the acceptability of the goals pursued by institutions. Therefore, the exact content of the performance guaranteed by consistent institutions should in addition be checked.

The performance of some institutions can be different in terms of (the various types of) economic efficiency as well as equity or some macroeconomic indicators, which in turn reflect different degrees of efficiency and equity. In the rest of the paper we will evaluate the performance of European institutions with respect to the goals established at Lisbon: sustainable growth, i.e., growth in a stability environment, and social cohesion.

A final test for institutions is given by their accountability and transparency at different levels. This not only has a functional role for stability, but is relevant *per se*, as it is an essential ingredient of democracy.

Accountability and transparency have recently acquired a growing importance especially in the macroeconomic literature with specific reference to the central bank because of the worldwide increase in delegation of authority over monetary policy to independent central banks. In Europe the debate is particularly intense since the formation of the EMS, which transformed those hitherto mainly academic questions into practical policy issues.

In democratic countries, accountability means the possibility to monitor the action of institutions entailed of a power delegation. With specific reference to the central bank, the relevance of accountability is in the fact that politicians, who are accountable to the electorate, should not delegate power to a specialised institution (making it independent) except if they can also exert control over that institution.

Transparency is instrumental for accountability. The commitment to particular policies should be verifiable by the politicians and the public that has the *original* power of delegation.

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[3] Calmfors (2001a, 2001b) is one of the few exceptions.

A particular attitude of the central bank towards information disclosure is hence required.[4] The two concepts of transparency and accountability are then inextricably linked. However, transparency can have a negative effect on the possibility for the central bank to stabilize the economy. It must be geared to two different targets (accountability and economic stabilisation), which introduces a trade-off.

Obviously enough, an institution (or assortment thereof) can be assessed in a different way according to the different criteria or the different aspects of each criterion. In such a case an economic analysis would not be sufficient for policy suggestions, which could only derive from political considerations. We will disregard the aspects of accountability and transparency, for which different conclusions can be reached from the various perspectives.[5]

3. The EMU entry requirements and the EU budgetary system.

As is well known, the actual EU budgetary system is scarcely a system in that tax and expenditure decisions are taken at the country level and the EU budget has only a limited size and scope. In addition, national budget decisions are subject to satisfaction of budget constraints. We start with discussing the rationale for introducing these constraints for the countries members of a monetary union – which we will show to be for some aspects similar to introducing some requirements for entering the union – and then consider the actual and prospective role of the EU budget.

Two kinds of reasons can be envisaged for introducing some sort of budget constraints: one refers to the general question of resorting to rules rather than admitting discretionary behaviour and is similar to issues arising in any single country; the other has to do with true problems of coordination among fiscal authorities and is specific of monetary unions.

The introduction of budget constraints and the recourse to a conservative central bank are justified by some economists on the basis of the 'Kydland-Prescott (1977) temptation of resorting to discretion rather than rules, thereby creating a worse outcome' (Uhlig, 2002: 28). These arguments are similar in nature to those developed with reference to a single country.

To show the advantages of having fiscal rules the following example is suggested. Suppose that we would introduce the SGP now. It is unlikely that Germany would support it. But Germany did press for it previously. The SGP and other rules try to avoid this kind of

[4] Central bank independence poses analogous problems. A central bank endowed with strong independence from the control of other institutions could be tented to pursue goals different form social welfare improvement. Such a temptation could be higher the lower is the central bank's transparency and accountability.
[5] From the economic perspective see Ciccarone *et al* (2004).

time inconsistencies and should then be adopted or strengthened (Uhlig, 2002: 28-29). One could easily argue that this example can be used just to show how dangerous these rules can be, as they are strangling European recovery. Our preference is definitively for more flexible rules. The relevance of the argument for credibility is often exaggerated, reflecting the different weight assigned to different policy objectives.

Contrary to Keynesian precepts, active fiscal policy and deficit spending risk being pro-cyclical, are barely effective, could introduce additional uncertainty into the system, and can raise doubts on their long-run sustainability, thereby increasing risk premia and interest rates. Instead of active demand management governments should pursue short-run stabilisation through the operation of automatic stabilisers[6]. However, the operation of automatic stabilisers is limited and they cannot optimally stabilize output. By contrast, unconstrained fiscal action (together with monetary action by a central bank sharing the same objectives as national governments) would lead to optimal stabilization (Tamborini, 2004).

Concern for misuse of political discretion has led some authors (Wyplosz, 2002) to suggest a kind of flexibility of fiscal policy shielded from political temptations and pressures, subtracting decisions about the deficit and the debt level from the political sphere and attributing them (only them and not other aspects of fiscal policy) to Fiscal Policy Committees independent of the Governments. This would follow the same path as monetary policy in its progressive detachment from the political sphere.

Such a solution is likely to reduce the budget deficit, but would probably increase another deficit, that of democracy, already there if we take the question of non-accountability of the ECB into account.

The second reason for introducing the SGP as a form of surveillance of fiscal policy has to do specifically with a monetary union once the union has come into existence. The same consideration asks for entrance requirements in the monetary union, in the form of fiscal policy rules, structural policies and labour market institutions. In fact, both the SGP and entrance requirements are often thought of as devices for avoiding a debt bail-out or negative spillovers of national policies on interest rates and the inflation rate.[7]

The argument for entrance requirements and after-entry surveillance based on negative spillovers lies on an extension of the literature on optimum currency areas. The size of an

[6] Artis and Buti (2000) estimate that the broadly balanced budgets required by the SGP are ‘roughly right objectives for most euro-zone countries’ (*ibid*, p. 587) and no contradiction exists between fiscal discipline and fiscal flexibility (*ibid*, p. 566).

optimum area is found to depend on many factors, among which are differences in structural policies. The working of EMU as an optimal currency area depends on the existence of small differences in structural policies, such as public indebtedness, labour market flexibility and the efficiency of the tax system. Differences in structural policies exert negative externalities from the laxer countries to more virtuous ones and affect the EMU inflation rate, the more so the less conservative is the Union's Central Bank. A conservative Central Bank could substitute for surveillance of fiscal and structural policies and avoid first-order welfare losses (Beetsma and Bovenberg, 1998, 2000).[8]

We will deal with the interaction between monetary and fiscal policies in the next section and concentrate now on the question of the negative external effects of strategic behaviour in decentralised public spending in the presence of discretionary monetary policy.

These negative external effects are certainly at work in reality. But we cannot jump to policy conclusions unless they are the only forces at work. If one asks whether inflation and budget deficit targets are the best devices for coping with externalities, the answer can be: Yes, as a first approximation, in so far as the negative externalities emphasized in the literature cited before are concerned. It could be: No, from the point of view of the positive externalities, which are not considered in that literature: expansionary budgetary policies in one country can have a similar effect in other European countries, thus easing the latter's budgetary problems. Those who underline the existence of negative externalities care about price stability; those who underline positive externalities give more weight to problems of unemployment and growth.

In order to stimulate the emergence of positive macroeconomic spillovers, *ad hoc* or institutionalised discretionary coordination is preferable to ceilings, which are a kind of passive (or negative) way of co-ordination, which tend to impress a deflationary bias to the EU economy.[9]

In addition to the limits already indicated, introducing uniform fiscal rules for all countries, in a system which already has a uniform monetary policy gives rise to other shortcomings. On the one side, "reconciling the 'close to balance' rule of the Pact with the high public investment needs of the new members – most of whom are still in a catching-up

[7] See Svensson (1997), Beetsma and Bovenberg (1998, 2000, 2002), Beetsma and Uhlig (1999), Beetsma (2001), and Allsopp and Artis (2003).

[8] Put in another way, this means that surveillance of fiscal and structural policies acts as an indirect instrument to deal with the problem of the imperfect conduct of monetary policy (Beetsma and Bovenberg, 1998).

[9] The 'passive' nature of the coordination among fiscal authorities provided by the SGP is recognized by Brunila, Buti and Franco (2001) and Brunila, Buti and Veld (2002).

phase – may prove difficult" (Brunila, Buti and Franco, 2001: 20). On the other, the SGP may have a high social cost also for the old members of the EMU, since the Pact "could limit the operation of the stabilisers in the countries that most need them" (Allsopp, 2002: 31). Thus the SGP 'could become a serious impediment to counter-cyclical fiscal policy if and when the EU falls back into recession' (Canzoneri and Diba, 2001: 56) and can restrain growth.

Introducing ceilings to deficits is also asymmetric, since no similar constraint is imposed on the surpluses that are required (as an alternative to balanced budgets) in the medium term. 'Imposing the double duty of medium-term fiscal restraint and short-term fiscal stabilisation… it was always quite likely that stresses and strains would emerge' (Allsopp, 2002: 21).

The need for a more active fiscal policy co-ordination at the EU level could be accommodated through a significant enlargement of the size of the European budget, which would help to pursue – in the spirit of the Lisbon Strategy – objectives of long-run growth and cyclical management, in addition to personal, industry and geographic redistribution.[10]

Certainly, there are obstacles to this or other looser kinds of active co-ordination. Some lack of 'European spirit' and the national governments' will to control a large part of each country's revenues may be invoked to explain that. Someone could add that budget decisions at a national level are more transparent and accountable, but this is not true, as in order to preserve accountability of budget decisions taken at the European level special *ex ante* and *ex post* publicity provisions could be introduced.

Other amendments to the SGP should be rapidly introduced in order to avoid the shortcomings of uniformity and asymmetry.

4. The role for a conservative central banker.

As is well known, the Charter of the ECB establishes an independent central bank and attributes a priority role to the objective of price stability. The decision to do so has historical, political and intellectual roots. We cannot get into a detailed analysis of such roots in this paper and limit ourselves to a brief discussion of the intellectual roots sustaining the decision to delegate monetary policy to an independent 'conservative' central bank.

The traditional result for the conservative central banker, due to Rogoff (1985), is based on the consideration that this can resist the temptation to 'cheat' or 'renege,' thus getting rid

[10] An increased role of the EU budget with respect to the three classic ('Musgravian') roles of government – such as to make it lose its actual feature of 'an historical relic' has been recently advocated by Buti and Nava (2003).

of the problem of the lack of coordination between wage and money setters and eliminating the inflation bias. Moreover, the recent literature (see, e.g., Coricelli *et al*., 2000, and Cukierman and Lippi, 2002) has given considerable attention to the effects on unemployment of a conservative central banker in a closed economy when many monopolistic wage setters operate, adding new results to the traditional view. In particular, if many labour unions operate in a context of monopolistic competition and do not take account of inflation, a conservative central banker can always reduce unemployment, in addition to inflation. In fact, a conservative central banker has an influence on real variables[11] since potential monetary restrictions *reduce* the free-riding behaviour associated with decentralized wage setting.[12] In a monetary union a similar role can be performed by the central banker interacting with national trade unions acting non-cooperatively.

As we said above, a conservative central banker can also avoid negative cross-country spillovers from fiscal policy profligacy in form of higher interest rates and inflation (Beetsma, 2001).

Apart from the question of alternative solutions to the problem of the inflation bias emerging in an economy with decentralised wage setting (which we will deal with in section 6), we should recognize that the existence of problems of reputation has been overemphasised in the literature (see Blinder, 1998; Meyer, 2002; Allsopp, 2002b). The practical consequence of this excessive emphasis is that, in order to build its reputation, the ECB has contributed to squeeze the economy to an impossible low.

A comparison between the ECB and other central banks, in particular the U.S. Federal Reserve – whose objectives are both price stability and unemployment reduction, with no priority attributed to the former with respect to the latter – may be in order.[13] The Fed's

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[11] Coricelli *et al*. (2000) and subsequent studies introduce the non-neutrality of monetary policy in a different way from the traditional approach, which is based on union inflation aversion (see Gylfason and Lindbeck, 1994). A full discussion of monetary policy non-neutrality in policy games can be found in Acocella and Di Bartolomeo (2004b).

[12] Seminal studies on the labour union coordination include, among others, Tarantelli (1986), (1987), and Soskice (1990). For some recent contributions see, among others, Soskice and Iversen (1998), Cukierman and Lippi (1999), and Coricelli *et al*. (2000). Coricelli *et al*. (2001) and Cukierman and Lippi (2002) explicitly consider the EU case. Cukierman (2004) offers a review of problems arising from uncoordinated wage setting. Calmfors and Driffill (1988), Calmfors (1993), and many successive papers discuss both coordination and centralization issues.

[13] Some experts like Allsopp hold that 'since the high inflation of the 1970s and the general recognition that there is no long-term benefit to allowing inflation to get out of control…the price stability objective is generally regarded as primary' by the Fed (Allsopp, 2002a: 5). One can, however, say that the interpretation of the primary role for price stability has certain been more liberal in the case of the Fed than for the ECB. Allsopp himself argues that various features of the ECB strategy should be changed in order to improve the perception of a positive role played in supporting growth (the asymmetric definition of price stability as less than 2% - now,

performance and impact on both inflation and unemployment is certainly not worse than the ECB's, in spite of the fact that it cannot be depicted as more conservative than the latter. One could say that a part of the merit of the impressive performance of the U.S. economy should be attributed to other institutions. In that case the simultaneous consideration of all the relevant institutions would be needed. That is what we intend to do in the next sections.

5. The coordination between monetary and fiscal policy.

The separation of policy responsibilities between the ECB (looking after price stability) and governments (caring for employment), at the basis of the Maastricht Treaty, begs the question of coordinating monetary and fiscal policies (Wyplosz, 1999).

This is an important question. As a matter of fact, the action of the monetary authorities and the governments of European countries in the Eighties and Nineties shows a failure to completely internalize the relevant externalities (Melitz 1997; Wyplosz, 1999). As is well known, a specific – and deep – failure to coordinate occurred in Germany after the reunification, leading to high budget deficits, high interest rates and an appreciating exchange rate. This repeated in some way the failure which materialized in the United States in the early Reagan years.

In analytical terms the relations between fiscal and monetary authorities in the EU – which initially we conceive as a single country – can be thought of at various levels, starting from the decision to lay rules to constrain fiscal policy (the SGP), then moving to the appointment of central bankers and finally establishing the actual policy mix. These decisions must be analysed by proceeding backwards, studying first the final decision level (Wyplosz, 1999).[14]

At the level of the actual policy mix, we must first recognise the existence of a trade-off between employment and inflation[15] and the nature of monetary policy and fiscal policy as strategic substitutes. The actual mix chosen will depend on the preference functions of the policymakers and the nature of the strategic interaction.

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after May 2003, less but close to 2% –abolition of the 'first pillar' – which has been done in May 2003 – greater focus on the existence of other objectives in the mandate of the ECB (see Allsopp, 2002a: 16-17).

[14] An additional level would be that of setting a ceiling to the inflation rate to be pursued by the central bank by means of a constitutional rule. In the case of EMU the Treaty establishing the European Community (now EU) does not give a precise definition of price stability and the ceiling is set by the Governing Council of the ECB. As said before, in 1998 price stability was defined as an increase of the HICP 'below 2%.' In May 2003 the Governing Council redefined it as 'below, but close to, 2%'.

[15] This can be explained in Keynesian terms or along Barro-Ricardian lines (Wyplosz, 1999).

As to the former, the higher the preference for price stability by monetary authorities, the lower the attempt to expand through fiscal measures. As to the latter, one of the most important aspects of the relations relevant for the policy mix is the existence of asymmetry between the two policymakers. One can argue that the fiscal authorities are (and should be) in the position of a Stackelberg leader, as they act less frequently than central banks do (Bean, 1998; Wyplosz, 1999; Allsopp and Artis, 2003; Dixit and Lambertini, 2004.).[16] In this situation no true problem of coordination between the monetary authority and the government arises if there is no disagreement about what the reaction function should be or a misperception about what it is, possibly due to differences in the underlying model of the economy. Even if they do not share common objectives, a problem of coordination would not arise, since, being leader, the government can choose the mix of fiscal measures and interest rates it prefers in order to achieve its output targets in the short or long run and the monetary authority can always determine the rate of inflation (Bean, 1998; Allsopp and Artis, 2003).

The problems that arise in this framework of one central bank and one government are more 'about supposedly inadequate or inappropriate policies' of the former, which can derive from 'disagreement about what the reaction function should be or, possibly, a simple misperception about what it is' (Allsopp and Artis, 2003, p. 14) due to differences in the underlying model of the economy or different diagnoses on the state of the economy (*ibidem*).

From this point of view one can share the view of the cited authors that the reaction function of the ECB should be appropriate to the real working of the economy. If the latter departs – as many economists think – from the natural-rate framework, it becomes relevant whether or not the monetary authorities pursue their subsidiary goals, i.e. goals other than price stability or are more activist.[17] Changes at the ECB which took place in May 2003 are but a minimal way towards a more flexible interpretation of the role and targets of the ECB. A revision of the Maastricht Treaty would certainly be in order to avoid the 'grease' effect that is likely to emerge at low inflation rates.[18] A similar effect can derive from the decision of the

[16] The argument is different in the two cases. As for the positive argument, one can say that fiscal authorities are somewhat committed to the policy they choose, whereas monetary action is more flexible. As for the normative argument one could say (as Allsopp and Artis argue) that elected institutions should be given the responsibility for fiscal action, even if they must have a clear knowledge of the consequence of their action on interest rates. From a purely economic point of view some argue that the optimal institutional arrangement requires national governments to be the leader of the game (see, e.g., Gambacorta, 2001).

[17] An aspect of the before-EMU conduct of European central banks noticed by Wyplosz (1999) is that they did not seem to react to fiscal policy. But, perhaps not surprisingly, they cared for both inflation and output, whereas governments did not behave like Keynesian activist. As to the reaction function of the ECB, 'the secondary objectives of the mandate have, however, certainly been downplayed' (Allsopp and Artis, 2003, p.9).

[18] See Akerlof *et al* (1996, 2000) and, for an application to Europe, and Wyplosz (2001), Holden (2004).

governments to appoint a more liberal central banker (the second level of the strategic interaction between governments and monetary authorities): in fact, the appointment amounts to ‘choosing the inflation rate that will ultimately be traded off against the budget deficit’ (Wyplosz, 1999: 47) and could help governments in finding a higher satisfaction of their preference function. At this level, the problem of coordination is more within the realm of the government. When nominating the central banker, it must anticipate that it will confront its appointee at the stage of setting the policy mix (Wyplosz, 1999). If it has a higher preference for employment, it will then appoint a more liberal central banker.

However, sometimes governments are schizophrenic or cannot anticipate the terms of future choices or are prisoners of modes. In addition, the confidence placed in governments[19] by the founding fathers of the EU institutions is not very high. They devised rules constraining fiscal authorities, which have the effect of improving the strategic position of the ECB. The ‘Brussels consensus’ (see Tamborini, 2004) is based on the idea that successful stabilization can be obtained if the ECB copes with symmetric shocks at the whole-area level and domestic stabilization relies on the working of automatic stabilisers.[20] In this picture there can only be a negative role for discretionary action of national governments, which should then be constrained. In fact, negative externalities from lax fiscal policy in one country of the kind already considered in section 3 might not lead to large and immediate costs for that country in terms of higher inflation, interest rates or exchange rates, since the effects could be diluted over the whole EU and delayed (Ghironi and Giavazzi, 1997). Generalisation of such a conduct would induce a second best situation of lax fiscal policies and high interest rates. The SGP is then a sort of coordination device that can avoid second best solutions. In addition to arguments related to externalities deriving from a multiplicity of governments, some authors hold that an ultra-conservative CB would optimally respond to fiscal distortions, whereas governments’ cooperation would entail negative effects on the level of production (Beetsma and Bovenberg, 1998). Alternatively, the SGP could be a device that ‘alleviates the

[19] We are now abandoning the assumption of only one government in the EU.

[20] This recipe is based on at least two assumptions: 1. Keynesian stabilization effects of fiscal policies are almost non existent in the short run and negative in the long run; 2. there is a tendency of governments to a continuous rise in public expenditure and deficits; this impairs fiscal discipline, which must be enforced by means of constitutional constraints and rule-based fiscal policies (Brunila, Buti and Franco, 2001). Surprisingly enough, these assumptions are the ‘heritage’ of the debate in the 1980s’ (*ibid.* p. 1) and have not been the object of recent theoretical investigation. For a critique see Tamborini (2004). As a matter of fact, automatic stabilisers in EU countries are only partially effective (Brunila, Buti and Veld, 2002; Farina and Tamborini, 2004)

need to adopt a Rogoff-type conservative central banker' (Wyplosz, 1999: 48).[21] Putting things in another way, one could say that 'the need for an ear to national public opinions calls for a role of the Governing Council of the ESCB while effectiveness calls for centralization and delegation of powers to the narrower Executive Board of the ECB' (*ibidem*, p.49).

Such justifications for a restrictive attitude towards active cooperation of national fiscal authorities and the appointment of a conservative central banker seem well grounded and rather compelling from a strictly economic point of view, i.e. disregarding political questions such as the need to respect democratically-formed preferences.[22] However, they only hold when the wage rate is given or, equivalently, unions pursue a fixed real wage target, disregarding any other objective. When this assumption is ruled out, the conclusions should be reversed (Acocella *et al.*, 2004a). To understand the rationale for this result, unions must be introduced into the picture, which we do in the next two sections.

6. Labour market institutions.

In Europe the debate on labour market institutions is very lively since a long time. Some economists and politicians often claim that Europe suffers from too many labour market rigidities, excessively generous unemployment insurance, high employment protection, and high minimum wages.

This claim does not consider that actual labour markets are far from being the textbook competitive markets. By contrast, information problems, bargaining and market power on both the workers' and firms' side are common in such markets. For this reason they will not work well without proper institutions.[23] By contrast, considering the possibility of multiple distortions in a second-best fashion, *flexibilization* or Americanization of labour markets may result to be counterproductive and cannot be assessed without taking account of the whole economic system, first and foremost the goods markets.

Notwithstanding our criticism of the 'flexibilization view,' current labour institutions are not optimal in any sense. They derive from market failures as the Great Depression or the

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[21] A strong support for a disciplined fiscal action at the level of member countries comes also from Lambertini and Rovelli (2004). For a review of the recent literature on the interaction between monetary and fiscal policy see Beetsma and Debrun (2004).

[22] Within this logic, the only shortcomings of the SGP are technical and the need only arises of tailoring it to particular country situations or making it taking account of particular events or the need not to compress public investment expenditures as underlined in section 3.

[23] For instance, in Europe trade unions have been able to provide insurance and help to their members, were the need to arise; to protect workers against rent extraction by firms; and to represent the interests of workers at the

Oil Shocks of the 70s and could be nowadays inappropriate in the new European and world scenario.

To get into details, most of the European unemployment is surely involuntary, and signals the existence of serious problems in the labour market, but this does not imply that there are bad labour market institutions, at least in the sense that Europe's problems stem from the fact that its labour market has institutions different from those prevailing in the United States and some other countries. Europe shows large differences in unemployment rates and at the low end of the spectrum there are countries with different institutions. On the one hand, Ireland, following a policy of liberalization and flexibilization has been able to reach an unemployment rate of 4.4%. However, Ireland's policy is also the result of a corporatist process involving all the social partners. On the other hand, in 2001, the unemployment rate stood at 2.5% in the Netherlands, 4.7% in Sweden, 4% in Portugal. These countries have achieved surprisingly low unemployment levels without adopting American-type labour market institutions. In addition, gross domestic product per hour worked in the private sector is actually quite similar across both sides of the Atlantic and France and Germany are clearly within sight of the US productivity level. However, analysing flows of job creation and destruction, reallocation of workers is unambiguously lower in Europe than in the United States. Even at the same unemployment rate, flows are lower in Europe than in the United States.

The debate is clearly more complex than simple slogans seem to suggest. Here we focus on the effects of labour market institutions on the macroeconomic performance. In particular, we focus on the role played by trade unions and their interrelations with other policymakers. For the sake of conciseness, we leave the discussion of the microeconomic and long run effects of labour markets institutions to other studies.[24]

Unions' strength is mainly measured by the degree of unionization and by the level where wage bargaining takes place (centralization), which varies between two extremes: the economy level and the plant level. The degree of centralisation of bargaining has been decreasing in European countries in the last three decades (Calmfors, 2001b). It is well known that (partial) decentralisation has negative external effects (Calmfors and Driffill, 1988). These arise because each union has a reduced perception of the inflationary consequences of

national level, either directly in consultation with business and government, or indirectly through political parties.

[24] See, among others, Traxler and Kittel (2000), Rhodes (2001), Blanchard (2004), Blanchard and Tirole (2003, 2004).

its wage setting for other unions, which tend to make them more aggressive, as they can beggar their neighbour. This is a powerful argument in favour of centralization of wage bargaining not only at a national level but also, in our context, at a European level. The need for centralizing wage bargaining at the EU level has been stressed recently by Hancké and Soskice (2003). By contrast, some other authors have preferred to follow a different line of reasoning and reach different conclusions. This line of reasoning is that of the conservative central banker and can be pursued at both a national and a currency-union level, in the presence of decentralised wage setting, as we said in section 4.

A conservative central bank solves the problem of coordination between the monetary authority and wage setters. It eliminates the central bank's temptation to inflate the economy in the attempt to reduce the real output gap and, therefore, eliminates the inflation bias. Moreover, if wages are set in an uncoordinated manner, the central bank also has an influence on the real output gap. This is due to the lack of coordination between the national labour unions, which are unable to internalize the negative externalities associated with wage bargaining. A more conservative central bank induces wage moderation since the unions understand that their attempt to export inflation when they raise nominal wages will be impeded by the central bank.

A conservative central bank is however only a second-best solution for internalizing the externalities arising from uncoordinated-wage bargaining, since wage coordination is Pareto superior to the non-cooperative solution for any possible value of the degree of conservativeness (included the case of an ultra-conservative central bank). In other words, the imposition of a conservative central banker only partially solves the problem of coordination between national labour unions. In this sense the central bank is not a perfect substitute for wage coordination (Acocella and Di Bartolomeo, 2004a).[25]

A critical remark may be that, although monetary unification will strengthen the incentives for higher level trans-national coordination of wage bargaining, such a development is unlikely in view of the coordination costs involved. A specific difficulty derives from the wide spectrum of current wage rates as between different European countries, but it does not seem to be decisive since co-ordination does not mean centralization, as is well emphasised by Soskice (1990).

Lars Calmfors (2001b) has pointed out two further critical points.

1. If trans-national coordination develops, it is most likely to occur within multinational firms.
2. Trans-national coordination conflicts with other forces working in the direction of decentralization and de-unionisation.

The points are relevant; however it must be noticed that a possible increase in the role of multinational firms can be the stimulus to endogenously induce the unions to coordinate their policies as otherwise their market power will be reduced.

The possible conflict between the union coordination solution to the European unemployment and the liberalisation doctrine is rather misleading. The liberalisation doctrine supports a generalized process of discarding European labour market institutions. However, as already argued, labour market liberalisation does not necessarily lead closer to the first best outcomes if other distortions, as in the European case, are present. Thus a more general strategy for the design of European institution has to be developed, based on solid economic cost and benefit foundations more than the likely biased view supported by some institutions.

7. Monetary, fiscal policies and corporatism.

According to a number of aforementioned authors, a tough central bank can entail a good economic performance. A complementary or alternative solution is deemed to be central surveillance on national fiscal policies (Beetsma and Bovenberg, 1998, 2000).

As we said above, these results have been obtained, and hold only, in the context of a unions' conduct parametrically given or, equivalently, of a union pursuing the sole objective of a given real wage rate. One can try to develop a different analytical viewpoint, which has been already suggested by a number of authors[26] and still has to be fully spelled out. This approach attempts at endogenising trade unions' behaviour by relating the unions' strategy to the conduct of economic policy. The conclusion can be drawn that policy prescriptions deriving from traditional models are ineffective as regards the possibility of reducing output distortions and should be reversed.

There are at least two reasons why trade unions' stance cannot be taken as parametrically given. One holds in a context where government's action only creates distortions, which are then strategic substitutes of wage distortions. In this context, with a

[25] However, as said before, conservativeness eliminates the problem associated with the lack of coordination between labour unions and the central bank (i.e. the traditional inflation bias). From this point of view it can complement wage coordination.

conservative CB, fiscal cooperation entails a higher output outcome, as it disciplines trade unions (Acocella *et al*., 2004a).

The other reason why unions' action cannot be considered as parametric has to do with corporatism. To examine this situation requires a rather long premise on the nature, types and reach of corporatism and social pacts. Corporatism is certainly an ambiguous concept. We define it as a set of rules of the game, i.e. 'institutional arrangements that involve negotiation, bargaining, collaboration, and accord between major economic groupings in the society, and especially between unions and governments.'[27]

In their golden age (the 1970s and early 1980s) social pacts aimed at exchanging wage moderation for higher public expenditure (namely welfare expenditure) or lower inflation (namely after the oil shocks).[28] Earlier empirical studies pointed out that corporatist economies exhibit a better performance in terms of inflation and unemployment (Bruno and Sachs, 1985; Calmfors and Driffill, 1988), while showing higher levels of taxation. At this regard, Summers *et al*. (1993) pointed out that in corporatist economies interdependence between monopolistic unions and fiscal policymakers limits the distortionary effects of taxes, inducing an exchange between public expenditure increases and wage restraint.

In recent decades there have been rather conspicuous changes in European industrial relations. Since 1987, when the first of five multi-annual pacts was stipulated in Ireland, there have been numerous formal or informal agreements, practically in all European countries, with the major exceptions of Belgium, France and – at least until the end of the decade – Germany. But the social pacts of the last fifteen years or so seem to differ from the earlier ones at least in one important respect, as they set out – rather than increases – reductions (albeit modest) in public expenditures and government actions protective of employment and labour rights (Regini, 1997; Visser, 2002). The common goal was a better economic performance and, mainly, achievement of political goals such as admittance to the EMU. Cooperation between governments and trade unions is thus continuing in a number of European countries and not only in those with a tradition of social-democratic government. Corporatism now has a different characterisation from that of the previous decades, as it implies a reduction in the level of state intervention in the economy. There could be several

[26] See among others Gylfason and Lindbeck (1994), Cubitt (1995), Cukierman and Lippi (1999), Allsopp and Artis (2003), and Hancké and Soskice (2003). See Cukierman (2004) for a review.
[27] This largely corresponds to definitions of 'corporatism' in Cameron (1984) and Bruno and Sachs (1985), Cubitt's 'Corporatism 4' (see Cubitt, 1995, and Burda, 1997).
[28] Unionised labour markets and a pervasive welfare system have long been the hallmark of European corporatist economies (OECD, 1997; Traxler and Kittel, 2000; and Rhodes, 2001).

explanations for this kind of new political exchange. First, preferences might have changed. For instance, the high unemployment rates experienced in the 1990s could have prompted a shift in union preferences, towards greater wage moderation. Second, the unions might have been changed their accepted model of the working of the economy. Finally, policymakers might have been aware of the risk that unilateral reductions in the level of the public sector budget would be frustrated by increased union militancy leading to excessive wage growth (Checchi and Lucifora, 2002).

Theoretical analyses of macroeconomic outcomes in corporatist economies are relatively scarce. In the Eighties, a number of economists and political scientists[29] argued that cooperatively determined wages can ensure the same disposable income for wage earners while resulting in a higher level of employment and a reduced inflation rate. After these informal studies a few theoretical contributions have appeared on the performance of a corporatist economy. A common result is that cooperation can improve macroeconomic performance.[30]

However, it is not guaranteed that unions’ welfare increases under cooperation. In fact, the unions’ objective function usually includes (in addition to employment and, possibly, inflation) the real wage rate. The tension between real wage and employment objectives may impede that cooperation improves both macroeconomic performance and unions’ welfare. Acocella and Di Bartolomeo (2003) find that feasible cooperation requires a high unions' interest in price stability. Acocella, Di Bartolomeo and Pauwels (2004) hint that indirect compensation through tax transfers or other kinds of *quid pro quo* might be a necessary component of feasible cooperative agreements.

The case for corporatist agreements can be revisited in a model of the kind we mentioned before where labour markets are unionized, the government controls the fiscal stance, an independent central bank sets monetary policy and, in contrast with the existing literature, the trade-unions' concern for public expenditures is explicitly modelled. The scope for a political exchange between public expenditures and wage setting choices can then be analysed, and corporatism is shown to generate macroeconomic outcomes quite different from the traditional exchange between wage restraint and high public expenditure. In fact, the model outlined can easily encompass both first and second-generation corporatist agreements. Most importantly, the model pinpoints the ineffectiveness of uncoordinated fiscal

[29] Such as, among others, Cameron (1984), Bruno and Sachs (1985) and Tarantelli (1986 and 1987).

retrenchments in unionized economies: in a variety of cases, the potential output benefits from fiscal discipline are eaten up by increased real wages (Acocella *et al*., 2004b).

The institutional arrangement derived from this analysis is consistent with the prediction of several authors that the EMU should produce a European social pact (Pochet, 1999; Traxler, 1999). This prediction has however failed to materialize until now and will not do so in the near future, at least for cultural reasons and inertia.[31] Emphasizing the advantages of the arrangement while underlining the difficulties it faces can facilitate the development of better institutions.

8. Stability vs. growth.

There are two tenets of the actual institutional architecture in Europe relevant for the connection between the short and the long run.

The first one has to do with the relationship between (price) stability and growth. The rationale for existing Europe's institutions lies in a strong positive association of the two: there is no long-run trade off between growth and price stability (Barro, 1997; Andres and Hernando, 1999). On the contrary, price stability is conducive to growth, as with low inflation the price mechanism is more efficient in allocating resources, inflation risk premia and fiscal distortions due to nominal tax systems are reduced, expectations are stabilised and confidence is promoted (see Winkler, 2003). Price stability must be pursued through appropriate monetary action by an institution committed to this goal.

The second tenet of actual European institutions has to do with fiscal policy. In section 3 we indicated the reasons for laying down rule-based uncoordinated fiscal action by national governments. In the minds of the founding fathers of the EU such rules – in particular, the SGP – can promote long-run growth while guaranteeing short-run stability and no trade-off exists between these two objectives. The credibility effect of the SGP can help in reducing interest rates, thus fostering investment and growth.

Both tenets are based on arguments that are at most partially valid. We first consider criticism of the former.

The positive association between price stability and growth is largely deduced from situations of high inflation; in the low-range of price increases, evidence of such an association is scanty. Instead of being conducive to growth, (price) stability can indeed

[30] See Gylfason and Lindbeck (1994), Burda (1997), Acocella and Ciccarone (1995), Acocella and Di Bartolomeo (2003), and Di Bartolomeo (2004).
[31] See Crouch (2000b) for an in-depth analysis.

hamper it, if it is pursued to an excessive extent, to the detriment of the output level, since hysteresis effects could operate.

Monetary and fiscal policy stabilization can have a negative impact on the steady-state equilibrium through:

1. capital accumulation and labour productivity (King and Rebelo, 1986; Stadler, 1990; Pelloni, 1997; Martin and Rogers, 1997, 2000; Blackburn, 1999; Fatas, 2000; Blackburn and Pelloni, 2002, 2004);[32]
2. structural effects in the labour market and multiple equilibria (Karanassou and Snower, 1998; Karanassou, Sala and Snower, 2002 and 2003);

As to the long-run effects of the SGP, in addition to the critiques previously expounded we must consider that it can be detrimental to growth essentially because the fiscal contractions necessary to avoid the SGP sanctions have pro-cyclical effects. This tends to make prices fall relative to the trend and thus to induce rising real interest rates even if nominal interest rates are falling, with negative consequences on investment and growth. This effect may well outweigh the short-term credibility effects on nominal interest rates and cause a pro-cyclical deflationary bias, increasing debt ratios and long-run instability (Hughes Hallett and McAdam, 1999).

9. Institutions for growth.

The ambitious targets of the Lisbon Strategy need a wide and deep reform of the European domestic institutions. Expanding the growth potential first requires structural reforms, mainly of a microeconomic kind at both the EU and national levels.[33] But there is also a need to revise features of the current macroeconomic policy setting and to redesign cohesion policies. Growth, stability and cohesion must go together, and stability should not have a priority role to the detriment of growth.

The need then arises of designing suitable macroeconomic (and cohesion) policies to achieve sustainable growth. At the same time, significant growth is necessary to maintain stability and cohesion.

[32] Most recent models that show a negative relation between recessions and growth are based on the existence of externality and learning-by-doing effects. However, reasoning along Schumpeterian lines, recessions would imply a cleansing mechanism for eliminating inefficiencies and raising the growth rate (Aghion and Howitt, 1998, ch. 8); similar effects would derive from mechanisms entailing substitutability between current production activity and R&D: recessions lower the opportunity cost of diverting resources from the former to the latter (see Aghion and Saint Paul, 1998a, 1998b).

[33] These are discussed at length in Hughes Hallett *et al* (2004).

The relationship between the EU as such and the Member States should be reconsidered. In fact, EU institutions, while keeping an essential role in enforcing commonly agreed disciplines must increasingly take on the role of a catalyst. The ‘stick policy’ may give some results, but a policy system that essentially relies on the threat of sanctions is neither efficient nor sustainable. Nor is a system viable that leaves so much to depend on loose and uncertain agreements among the Member States to deliver on commonly agreed objectives. More active rather than coactive coordination is requested; according to this view the need is to move towards a more incentive-based approach that treats Member States as partners (Buti *et al*., 2003).

By removing barriers to the mobility of goods, services, labour and capital, the European integration, since the Common Market creation, was intended to foster competition, to boost productivity and to accelerate growth. However, European growth has been mediocre with reference to both its past performance and the current American trends. This notwithstanding the size of the home market, the high level of human resources, capital and infrastructure, the potential for catching up with the United States and the efforts made to promote more competition. It has now become clear that the context in which economic policies have been developed changed fundamentally over the past thirty years. A system built around the assimilation of existing technologies, mass production generating economies of scale and an industrial structure dominated by large firms with stable markets and long term employment patterns no longer delivers growth in today’s world, characterised by economic globalisation and strong external competition.

The new need is for a massive change in economic institutions to support a production structure based on less vertically integrated firms, greater mobility within and across firms, more retraining, greater flexibility of labour markets, greater availability of external finance, in particular equity finance, higher investment in both R&D and higher education. The engine of growth is innovation and in this direction the European Union can be a prime actor, by patents regulation, investment policy and more in general its contribution to the general innovative climate.

Some requested reforms may entail high social costs. A large part of the literature has pointed out the rent problem. Deregulation in product markets implies a reduction of firms’ rents – particularly in the service sectors – and possibly of workers’ as well. An issue of specific relevance for growth is the content of long-run agreements between policymakers and unions. The evidence on this issue is mixed. However, when unions focus on variables other than short-term wage increases, corporatism may even outperform a non-unionized economy, as knowledge formation and innovation can be induced through long-term wage moderation accords (Palokangas, 2000). Cursory evidence shows that in a number of cases corporatist agreements have created a growth-friendly environment (see Traxler and Kittel, 2000; Traxler *et al*., 2001; Rhodes, 2001; and Visser, 2002).

Another important issue has to do with the long run implications of the use of policy instruments – such as fiscal policy – which are studied mainly for their short run effects (Zagler, 1999, 2004).

The key role of the government budget is evident to pursue the Lisbon strategy. Three issues must be considered in this respect. First, the size of the European budget: Europe should refocus on the EU budget to make it consistent with a Lisbon-oriented approach. Second, the composition of the expenditure both at the EU and the national level: this is crucial since different kinds of expenditures are associated with favourable or adverse effects on growth.[34] Third, structural reforms tend to require substantial outlays and – for that reason – a more flexible implementation of the SGP (Beetsma and Debrun, 2003)[35] or its cancellation.

Finally, another argument against the current EU policy design is as follows. The deeper and more extensive institutional reforms needed for long-term convergence take time to implement and mature and thus such reforms can be much easier to undertake in an environment of growth rather than stagnation. This consideration suggests that successful growth strategies are based on a two-pronged effort: a short-run strategy aimed at stimulating growth, and a medium- to long-run strategy aimed at sustaining growth (Rodrik, 2004).

10. Conclusions.

European institutions show three kinds of biases: i) a bias in favour of markets; ii) a bias in favour of rules; iii) a bias in favour of short-run stability (notably price stability).

They had a clear bias in favour of markets in the earlier stages of European integration, but have later developed to some extent towards a greater role of the government, at various levels. The bias in favour of markets has however continued to shape public intervention as the discretionary role of governments has often been severely constrained by commitment to some objective as well as introduction of ceilings and rules.

[34] See Perotti (1996), Alesina and Perotti (1997) and Von Hagen and Mundschenk (2001).

Traditional models of fiscal-monetary policy interdependence developed in the Eighties and Nineties highlight the importance of institutional arrangements in shaping the behaviour of macroeconomic policymakers. Typically central bank conservatism and institutional constraints to fiscal discretion are deemed to enhance macroeconomic efficiency, i.e. to produce lower output distortion and inflation. The policy prescriptions derived by the models of the Eighties and Nineties together with historical roots explain the third bias of European institutions, that in favour of short-run (price) stability and against growth: the former was considered as a precondition of the latter. An unfounded obsession for the possibility of cheating and the necessity to ensure an environment of price stability has actually led to a situation of quasi-stagnation. Institutions favouring stability have thus been promoted to the detriment of growth.

The models which inspired the shaping of Europe's institutions have taken a rather schizophrenic attitude towards labour market institutions. Some analyses implicitly or explicitly assume a given labour market performance and, thus, given labour market institutions, neglecting interactions between them and fiscal and monetary policies. Some other analyses consider the relationships between the labour market and these policies but tend to view labour market institutions as mechanically dependent on them. In this vein, e.g., a conservative central banker can have a whipping effect on unions' behaviour, thus inducing their virtuous conduct and a reduction in output distortions.

We have argued in favour of explicitly modelling the trade unions' behaviour and shown that policy prescriptions deriving from traditional models that do not so are ineffective as regards output distortions. The first key to this result lies in the consideration that, beyond the real wage rate and employment – which have been the object of traditional analysis – unions may also be interested in the level and/or the composition of public expenditures. The second key lies in the re-examination of corporatism as a feasible set of institutional arrangements designed to internalize some negative macroeconomic externalities and to provide a positive solution to them, alternative to the punishment suggested by much of the previous literature. The third key is in the consideration of the government budget as a kind of two-faced Janus, i.e. in its double role of providing public expenditures valuable for the union members and extracting distortionary taxes. This characterisation of the budget makes it possible to derive policy conclusions consistent with the observed evolution of social pacts

[35] It is a strange aspect of the life that people and states who most supported the SGP at the time when it was introduced ask now for a more flexible implementation of it.

over the recent decades, which seem to mark a transition from an exchange between wage moderation and higher public expenditures to one between wage moderation and lower public expenditures.

This analysis has relevant implications for the current debate on institutional reforms in Europe. Discussions about the reform of the SGP as an instrument to regulate externalities deriving from separate national fiscal policies neglect considering its impact on labour market performance and the contribution that the labour market institutions can give to a positive solution of coordination problems. The suggestion is that, when the within-EMU interdependence of national fiscal policies and national labour market outcomes is considered, any strategy of putting a cap on public expenditure is doomed to be ineffective as reduced tax distortions could be substituted by higher labour market ones. By contrast, corporatist institutions should be regarded as valuable tools in enhancing macroeconomic performance. These would be in line with the recent debate on Lisbon strategy that emphasises the role of social partnership.

An alternative solution to discipline the labour market would be to remove distortions by a complete liberalization. However, the risks of this strategy should be clear: on the one hand, from the hump-shaped curve suggested by Calmfors and Driffill (1998) we know that corporatist agreements are likely to dominate partial labour market liberalization and, on the other, a complete decentralization may be politically unfeasible. The kind of institutional strategy outlined above is clearly consistent with the Lisbon strategy when it tends 'to drive job creation alongside social and environmental policies that ensure sustainable development and social inclusion.'

More generally, a number of institutions – in addition to the labour market ones – should be reconsidered in order to pursue the long-run objective of growth. They have to do mostly with microeconomic policies, but macroeconomic policies have also an important role to play, e.g., strengthening the EU fiscal policy and budget is a precondition for innovation-fostering action as well as the significant redistribution across countries and industries that should accompany – and in some cases – make innovative policies easier.

Social partnership has however an additional specific role to perform. It contains something of a challenge as its development requires – but also favours – deeper forms of democracy. There has been concern that basic political institutions of democracy taken for granted at the level of the countries member of the EU have not developed along with the pace of mechanisms of economic integration (Verdun, 1998; Crouch, 2000a). After all, departure from rules and constraints can be really effective when the conduct of policymakers can be made sufficiently benevolent by social control and stability, collaboration and accord.

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