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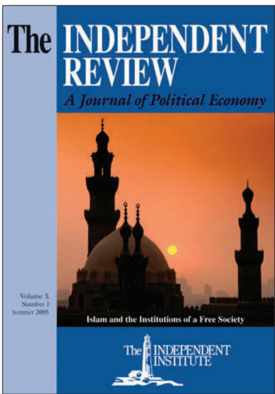

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The Crisis of Europe's Centralized Federalism

Ambiguities of a Harmonized Currency Union

ENRICO COLOMBATTO

Despite their high hopes for spontaneous, widespread popular support for economic integration, the champions of the European Economic and Monetary Union (EMU) are still trying hard to persuade the public of the benefits of the new common currency.[1] Notwithstanding these efforts, many Europeans do not know much about the EMU and remain cautious in their assessment of the new currency. Others are more skeptical (Meerhaeghe 1995). In this article I attempt to expand our understanding of the lack of popular enthusiasm and to shed some new light on the future of the euro. Three issues will be considered.

First, I discuss the implications of the questionable legitimacy of the European Union as a cultural or political entity. In particular, it remains unclear to most why the creation of a new, common currency should be instrumental for harmonizing national cultural traditions and institutions. Nor is it evident why such national traditions and institutions should be harmonized in the first place. Hence, the clamor to strengthen the European ideal from a political, social, and economic viewpoint often leads to apprehension rather than to deep emotional commitment. Many groups are cautious in forming conclusions about the common currency. For the euro has become the

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symbol of future policies that policy makers have decided should be "common" even before their precise content has been agreed upon, let alone explained to the public. The skeptics include not only those who are suspicious of enhanced (centralized) policy making but also some proponents of extensive policy making.

The second issue pertains to the partial failure to perceive what happened on the way from Rome (1957) to Maastricht (1992) and Amsterdam (1997). By and large, people understood and appreciated the benefits generated by the drive to achieve free trade and free movement of production factors (including capital). It was fairly clear that these efforts would lead to a more efficient use of resources and an increase in consumers' purchasing power. In other words, the notion of a common market was the essence of the Treaty of Rome, which established the European Economic Community (EEC), and enjoyed widespread support because it identified both the instruments and the goals in a transparent way. But the same cannot be said for the European Union, which focuses on broad, hardly objectionable goals, such as reducing unemployment or enhancing competition, but is much less convincing about the instruments. For instance, EU supporters argue that the common currency will eliminate exchange-rate risk, reduce interest rates, stimulate investment, and increase the demand for labor. P. De Grauwe (1997), however, has presented extensive evidence on the lack of causality between investment and exchange-rate volatility. And it is widely accepted that the introduction of a common currency into a less than optimum currency area leads to more, not less, unemployment.[2]

The project for a monetary union is also veiled by ambiguities. The emphasis on the instrument (the euro) is clear, but the objectives are vague. The person in the street cannot help feeling bewildered when told that the EMU is the natural development of the original idea of a common market conceived more than forty years earlier. And rightly so, because a monetary union has little to do with the achievement of free trade and of free markets in general.

The last group of questions I consider here pertains to the uncertainties associated with the perceived meaning of the EMU, and the way that perception has changed during the 1990s. Ten years ago, the EMU was understood to identify the leading countries of Western Europe that aspired to take responsibility for policy mak-

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1. According to the official EU Web site, the advantages of the common currency are price transparency and therefore enhanced competition; lower unemployment; better monetary policy; no exchange-rate risk for intra-EU transactions; lower interest rates; higher investment and higher growth overall. See Wihlborg 1994 and Bernaldo de Quirós 1999 for a critical review of the main arguments; see also El-Agraa 1998. In fact, the only undisputed benefits are the reduced costs that tourists will incur when changing their cash balances as they travel from one European country to another; and seignorage, if the Euro turns out to be successful as a reserve currency.

2. In fact, the solution to the European unemployment problem is deregulation in the labor markets. But nobody could stop Italy and France from adopting the so-called 35-hour-week legislation if they decided to do so. Nor could they be prevented from distributing relief (subsidies) to producers as a form of compensation. It is indeed telling that resistance to a de jure reduction of the workweek comes from national interest groups, not EU policy makers.

ing in that part of the world. But as time went by, the elitist features of the union gradually disappeared. The original D-mark core plus France has become a much larger region including eleven countries, and possibly more in a few years. As a result, although many feel nervous about being "left out,"[3] they are still hesitant about the reasons for adoption of the common currency and skeptical about the future role the new structure will play in policy making.

Can the Euro Provide Legitimacy to the European Ideal?

M. Franklin, M. Marsh, and L. McLaren (1994) have noted that as long as the euro was perceived as a monetary technicality with rather remote practical consequences, public opinion in Europe remained by and large indifferent to the creation of the EMU. It is probably more appropriate to claim that although a very large share of the European population remained ignorant about the workings of the euro and of the future monetary union,[4] many were actually prepared to welcome the introduction of the new European currency.

Of course, it is not surprising that support was widespread in those countries with a reputation for high inflation, such as Greece, Spain, and Italy. This consideration also explains why emotions were much cooler in other parts of Europe, where monetary policy and national politicians were held in higher esteem. As documented in many surveys, the public in the former group of countries tended to believe that a European Central Bank (ECB) would provide better protection against inflation and that the EMU would serve to reduce the discretion of local politicians.[5] People in the D-mark area, on the other hand, tended to regard the euro as a threat to that area's tradition of monetary stability but viewed the EMU as an opportunity to weaken the links with the economies that would fail to meet the admission requirements.

Overall, and in sharp contrast with historical precedents,[6] the euro was not perceived as the symbol of a common European identity, either at the beginning of the 1990s or back in the 1960s, when the project for a European common currency was

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3. For instance, H. Védrine, the French minister for foreign affairs, stated that "Great Britain cannot yet have in Europe the same role as those countries which have created the Euro and will join in. . . . It seems to me that Britain can only play as full a role as France and Germany from the moment it is inside the Euro" (*Daily Telegraph,* October 6, 1998). Similar remarks were made by J. Fischer less than a week before he was appointed minister for foreign affairs in the German government (*Economist,* October 10, 1998). See also Feldstein 1997 on the political implications and consequences of being "in" and staying "out" of EMU.

4. According to Eurobarometer (*Economist,* February 1, 1999), in 1998 only 25 percent of the population of the eleven EMU countries had adequate information about the new currency. The Netherlands had the highest share of informed people (43 percent).

5. See, for instance, Müller-Peters, Pepermans, and Kiell 1998 as well as Scacciati 1998 for recent surveys and references.

6. As described by Cohen 1993 and Bordo and Jonung 1999, all past monetary unions were preceded by political unification, which led to adoption of a common currency. Thus, contrary to the euro case, which is indeed unique in this respect, the idea of political union provided the justification for monetary union.

first conceived and the Soviet threat could have been a compelling argument for (Western) European unification.[7] In fact, in the 1960s the support for a common currency came from the weakness of the dollar and the collapse of the Bretton Woods system, and that support led to the European Monetary System (EMS) and the European Currency Union (ECU). In contrast, in the early 1990s the support came from the desire to replace discredited national policy makers with foreign, allegedly independent technocrats or from the Franco-German desire to establish political hegemony (Feldstein 1997).

Support is not the same as legitimacy. According to Anthony de Jasay ([1985] 1998, 77–78), an institutional arrangement can be considered legitimate if it is accepted in the absence of sanctions or incentives. This condition applied to the former ECU, which was introduced as an alternative currency, but certainly not to the euro, which will make all the existing EMU currencies illegal means of payment. This dearth of legitimacy was not troublesome at the end of the 1980s, when the euro proposal was discussed mainly in technical circles. On the one hand, the legitimacy of technicalities tends to be relatively difficult to analyze, hard to question, and almost impossible to transform into a topic for public debate. On the other hand, the euro proposal tended to be assimilated to a matter of monetary coordination, a concept with a long tradition and little effectiveness in the European debate. It is hardly surprising that public opinion regarded the common currency as something vague and temporally remote, by and large ignoring its implications for centralized policy making.

The questionable legitimacy of the euro became apparent, however, when the EMU idea evolved into a political issue.[8] In other words, in spite of persistent backing from the media at large, caution vis-à-vis the euro started to build up when euro supporters attempted to associate the technical concept of monetary union with the rather ambiguous objective of "harmonization" promoted by the EU in general and by the EMU in particular. Harmonization is of course a euphemism for centralized law-making, whereby the rules of the game (legislation having direct economic consequence) should be roughly the same throughout the area.[9] In practice, the EU authorities are to

7. In this respect, V. Giscard D'Estaing and H. Schmidt played the leading role in the decade from the late 1960s to the late 1970s. They first thought of a common currency as soon as the collapse of the Bretton Woods system appeared inevitable. In their view, the new currency's purpose was to protect European free trade against the trade wars that might result from possible devaluations by some members of the Community (*Herald Tribune,* December 10, 1998). Their proposal was then formalized in the Werner Report (1970), which also introduced the case for economic convergence. As discussed later, the idea of political union played a secondary role in the minds of the EU architects until the free-trade goal was replaced by more ambitious objectives of common policy making.

8. As S. Strøm has pointed out (in private correspondence), in some countries—Scandinavia and the United Kingdom, for instance—the euro was perceived as a political issue from the start. In fact, opposition to the EMU project was manifest from the very beginning.

9. For instance, in April 1999 Prodi stated in a speech warmly received by the European Parliament that "we must now face the difficult task of moving towards a single economy, a single political unity. . . . The ambitious task we have set cannot be carried out with the present institutions." This declaration was consistent with the fall 1999 proposals to enhance the power of the EU—and of the President of the Commission in particular—vis-à-vis the member states. See *Daily Telegraph,* April 14 and October 18, 1999.

enact legislation stating the principles and minimum requirements that the national authorities should take into account and include in their national law-making process. The EU authorities are then responsible for evaluating whether such principles and requirements have been adopted within the prescribed deadlines and guidelines and, when necessary, for imposing modifications. Furthermore, harmonization and subsidiarity together can lead to direct local intervention by central authorities, bypassing the national authorities.

At first sight it may be tempting to discuss the introduction of the euro and the principle of harmonization separately, as if they were two different matters. But they are not independent in the EU context, where the euro has ceased to be a mere monetary technicality and has become a political matter because of harmonization. The issue of harmonization raises doubts among those who believe in free-market ideals as well as among those who advocate significant government intervention.

We must recognize that the EU is far from being an optimal currency area (OCA).[10] As its members are exposed to changes in demands and supplies, they may suffer severe economic imbalances (Schwartz 1997 and, more generally, De Grauwe 1997). Furthermore, given current conditions, the economies belonging to such a union can take divergent paths even in the absence of asymmetric shocks, as a consequence of their different tax systems, overall legal frameworks, and political conditions.[11] Therefore, the public interest cannot be pursued only by having a European monetary union per se, because it would not be an OCA. Nevertheless, such a monetary union could still be desirable if it is actually suitable to bring about an optimal currency area, with acceptable costs, and if such an OCA is in fact appealing. Hence, a preliminary step is to understand what kind of OCA the euro supporters have in mind.

The much-proclaimed principle of harmonization is of considerable importance in this respect; for that principle relates to the accomplishment of two specific versions of an optimal currency area. According to one version, harmonization would bring homogeneity across countries in production structures *and* in institutional conditions (the rules of the game). As a result, asymmetric shocks would be less disruptive. A second version of harmonization stresses that potential divergences within the currency area would be compensated and smoothed by substantial transfers from one set of countries to another. Put differently, those who support the principle of harmonization and the creation of an OCA—that is, a harmonized OCA—necessarily aim at monopoly power

10. As suggested by a referee of this journal, this fact alone should be enough to rule out the common currency, for it would go against the principle of subsidiarity. Indeed, in the light of the euro experience, it seems that subsidiarity does not apply in all contexts, but only when it is invoked by the policy makers. This practice leads to trouble when national and federal policy makers hold different views.

11. A recent example is the evolution of the real cycle in the 1990s, which has shown an uneven pattern throughout the EU area. See the Supplement of *The Economist,* April 11, 1998, and De Grauwe 1994, which emphasizes the role of asymmetric policy making in Europe during recessions.

to enact legislation that would be applied to the whole area with no regard for national differences; or they aim at substantial federal welfare programs; or they aim at both homogeneous legislation and federal welfare.

But is the common currency the appropriate tool to achieve a harmonized OCA? And is a harmonized OCA really desirable? The evaluation of the use of a common currency to create an OCA can take different paths and lead to different objections, depending on whether one takes a public-interest or a public-choice approach.

Doubts from the Public-Interest Viewpoint

The public-interest view of policy making maintains that politicians and bureaucrats operate in the general interest of the electorate for two reasons: first, because public representatives and officials have been selected according to their ability to pursue and satisfy the public interest; second, because politicians and bureaucrats compete with one another, and only those who come closer to satisfying public expectations will remain in power. Those who fail will be replaced by "better" policy makers.

Those who take the public-interest view of policy making will fail to see why harmonization is a necessary step toward better policies. If federal policy makers do pursue the public interest, then their policies should take into account national and regional features that conflict with the principle of centralized decision-making (harmonization) and that may be difficult to level by fiat. More important, if policy makers do act in the public interest, there is no need to replace national by federal policy making, except in those few cases where externalities are significant. On the contrary, if a necessary condition for policy makers to behave in the public interest is that they are in competition for consensus, harmonization greatly weakens that condition. Centralization implies that the electorate cannot observe and compare different institutions, express their preferences by taking into account the results achieved in other countries, and then stimulate national policy makers to adjust their activity accordingly. Thus, harmonization reduces the choices among different systems as well as the potential to carry out local experiments to improve the institutional framework. In short, harmonization weakens the incentives to conduct good government.

The creation of a *non*-harmonized currency area would have been acceptable from a public-interest viewpoint as long as its costs had been less than its expected benefits. By creating strains and disequilibria within the area and by eliminating one important tool available for second-best adjustment (the exchange rate), a common currency could have made the situation so bad that the demand for institutional reform would have become much stronger. Then, competing politicians would have reacted accordingly and provided better law-making. In particular, pressure would have built up to make labor mobility effective and to remove legislation that prevented flexibility in nominal prices. But such an outcome cannot occur in a harmonized

OCA, where strains are likely to generate monopolized policy making rather than competitive government actions.

Doubts from the Public-Choice Viewpoint

In the public-choice view, politicians and bureaucrats pursue their own personal interests. The presence of significant transaction and information costs makes it difficult for the public at large to acquire adequate information about the nature and consequences of many policy-making actions. Similar impediments also apply to monitoring and sanctioning. Of course, there is a limit to bad policy making, beyond which popular protest erupts and the incumbent politicians are removed from office. But such a threshold is often high, and politicians are usually shrewd enough not to go beyond it. Proponents of public choice naturally tend to be uncomfortable about government intervention. They tend to oppose all institutional arrangements that might raise the threshold below which government agents and their clients are free to carry out rent-seeking activities.

In the public-choice view, government intervention is inefficient, but it is nevertheless acceptable where it is less inefficient than the private solution. Thus, intervention may be justified where important collective-action problems exist; national defense and law-and-order are the traditional examples. Today's concept of harmonization, however, refers to a much wider range of actions. In particular, it implies a transfer of authority from local and national governments to a central federal level. The public-interest grounds for this relocation of power are weak. On the contrary, information costs for the public at large tend to become higher and, ceteris paribus, to create more opportunities for rent-creating and rent-seeking activities. Information and transaction costs for the more powerful interest groups may actually fall, because those groups' counterparts are no longer a relatively large and heterogenous number of national and regional authorities, but only one bloc of bureaucrats at the center.[12] Finally, it is hard to see in which domains centralized policy decisions implemented throughout the whole area are better—or, to be precise, less ineffective—than decentralized decisions. Hence, although national policy making enjoys some legitimacy as long as it remains within limits, centralized policy making does not.

Surely nothing justifies a common currency per se as a source of legitimacy. There is no theoretical or empirical support for a monopolized monetary management. Of course, even before 1999, Europe was far from having a free-banking system. Agents were not free to create new currencies, and the national currency was the

12. The EU is ruled by a professional bureaucracy, the European Commission, which is de facto responsible for both the legislative and the executive functions of government. As described by Nicoll (1996), attempts to weaken its prerogatives—say, by giving more power to the European Parliament—have met with limited success. The most recent examples are the fight about the terms of approval of the Prodi Commission, the outcome of which has been all but humiliating for the Parliament, and the fall 1999 proposals to expand the power of the Commission and of its president.

only legal tender in the various countries. However, the exchange rate was perceived as one of the foremost indicators of the quality of policy making. Hence, although competition for a strong currency—that is, exchange-rate stabilization—did not necessarily lead to better policy making, it did lead to better currencies (limited inflation). In other words, although the legitimacy of national monopolies was questionable, they could be tolerated because of continental international competition. The introduction of a new common currency might have been welcomed, for all new competitors are welcome as long as they respect the rules of the game. But the forced replacement of the incumbent currencies by a new one is arbitrary; it gives rise to weak legitimacy for the euro relative to previous national currencies.

Summing Up on Legitimacy

The euro per se has scant legitimacy. Might the euro draw its raison d'être from the European ideals? Probably not, for the European political ideal itself lacks legitimacy. As explained at length by D. Obradovic (1996), most European countries have different myths, history and traditions, institutions, and systems of values. The distance between actual conditions and the rule-of-law ideal has always varied greatly, and in a variety of ways, across countries. As the literature on institutional economics has made clear, this variance has led to the proliferation of different systems of informal rules and thus different cultures. Generations of time would be required to eliminate such peculiarities, and their elimination may not be desirable in any event. Certainly such institutional homogeneity cannot be achieved in just a few years. All attempts to force it to develop by introducing a new, common system of codified rules through a top-down process—which necessarily ignores local cultures—will inevitably lead to tensions and ultimately to the crisis of the whole system.

Yet, European institutions are indeed the result of a top-down decision-making process led by elites, with little concern for popular demands. All over the EU the elections to the European Parliament have always had little to do with Europe. Instead, they are a national events—in effect, formal opinion polls on the incumbent national governments. European candidates are chosen not according to their views on the major issues of continental interest, but according to their actions on the national scene. Nobody cares if many members of the European Parliament seldom show up at Strasbourg or Brussels. Similar comments hold true for the Commission. Its composition has always been regulated by a strict rule about the number of commissioners from each country; merit and ethical standards are welcome, but not necessary, as the Santer Commission has shown. The appointment of the President of the Commission is one of the few issues that arouse nationalist sentiments irrespective of the political divisions within the member countries.

In short, the euro project does not legitimize the EU, nor is the euro legitimized by the EU, because the EU itself lacks legitimacy. In this light, Continental

harmonization is put forward as a substitute for legitimacy. More accurately, according to the EMU party, harmonization should justify EU policy making from a functional viewpoint (providing an imperfect substitute for legitimacy[13]) and should serve as a rationale for having the euro, which in this case would be merely an element of the centralization process. Unless one accepts the need for, or indeed the legitimacy of, harmonization on a European scale, a new currency in a far-from-optimal currency area makes little sense. But the need for harmonization is hard to accept, and therefore the argument in favor of functional legitimacy is particularly weak.

From a public-interest standpoint, inefficiencies and overregulation could have been dealt with best at a national level, possibly in a context of competing institutions. Instead the common currency eliminates, or greatly curtails, the scope for competition among policy makers, who no longer feel pressed to pursue the public interest. If people had felt the need for a new currency, its introduction would have been welcome. Much less welcome was the creation of a legal monopoly and the forced replacement of the existing currencies. In fact, a unique European currency ignores the relevance of the differences created by distinctive cultural and institutional features. The fear that the economic consequences are bound to be offset through transfers effected within the central budget is thus justified (Obstfeld and Peri 1998).

From a public-choice perspective, harmonized policy making is synonymous with centralization, provides enhanced opportunities for rent-seeking, and leads to poor policy making. In particular, the common currency is perceived as a strong limit to policy competition, and it is bound to create further imbalances across Europe, at least until harmonization is completed. Such imbalances will be particularly manifest in the labor market, but fixed capital may be affected as well. Those affected by the imbalances will solicit political activity, either demanding additional income redistribution or opposing such demands.

What Happened to the European Communities?

I have just argued that one of the critical weaknesses of the EMU undertaking has been its emphasis on harmonization, a concept that runs against both the existence of diverse cultures in Western Europe and the need to create new opportunities for economic growth through enhanced policy competition rather than centralization. But the creation of the EMU has met other obstacles as well.

13. The distinction between legitimacy and what could be defined as functional legitimacy is important. The former applies to an institutional framework or a norm that codifies and makes explicit an informal rule (see Leoni [1961] 1991 and de Jasay [1985] 1998). The latter is a much weaker concept. It applies to an instrument introduced by the authorities in order to achieve a commonly desired objective. This functional version is weak because such instruments often produce side effects, whose aggregate desirability is much more questionable than that of the ultimate goal.

The drive toward a harmonized currency union and extended policy making at a federal level has signified a major break with the postwar legacy of European integration. Surely, the EEC Treaty already allowed some latitude for policy making even before Maastricht. Nevertheless, until the late 1980s the EC enjoyed unlimited approval in all quarters mainly because of its commitment to free trade, not because of its ambition to play a greater political and regulatory role.

In the beginning, the legitimacy—and therefore, implicitly, the limits—of European integration arose from military needs after World War II. The desire to reduce the likelihood of future conflicts within Western Europe played an important role, especially at the Hague Conference in 1948. Probably more important was the threat from the East bloc. Indeed, the first serious attempt to create some sort of a European union was the formation in 1952 of the Communauté Européenne de Defense (CED), which received the blessing of the United States. Likewise, U.S. blessing accompanied the creation in 1954 of the Western European Union, which replaced the CED, and, in 1957, of the Common Market (plus Euratom).

However, the military and nuclear side of the integration process has probably been disappointing, to say the least. Although R. Inman and D. Rubinfeld (1998, 14) have claimed that "the desire of France and Germany to avoid military conflict on the Continent" remained the driving force of the European Community until the Maastricht Treaty, it is unlikely that the EC could have survived with military legitimacy alone. In fact, the emphasis had already shifted dramatically from military aspects toward free-trade objectives at the Conference of Messina (1955) and later with the Treaty of Rome (1957).[14] Although the legitimacy of European integration did spring, immediately after the war, from a widespread desire for a common defense, that goal was gradually more or less replaced by a free-trade objective, generated by expectations of high economic growth (Colombatto forthcoming). More precisely, free trade became the functional legitimation for European integration. And because commercial liberalization was taking place in a context of rapid economic growth, the cost of adjustment was modest. Hence, the gap between legitimacy and functional legitimacy could hardly be perceived.

The EEC took advantage of its trade-based legitimacy to develop projects and policies in areas where its legitimate authority to operate was much more questionable, and surely not inspired by free-market principles. The case of agriculture is telling in this respect. Similarly, complaints about "Fortress Europe" were often appropriate (Frankel and Stein 1993; Dhara and Panagariya 1995). Still, most of these projects, including those on regional policy and social policy, based on the Treaty of

14. To be precise, the shift toward trade matters took place earlier, with the Beyen Plan (1952), which the French considered unacceptable until 1955. See Zanghì 1995 for detailed accounts of the different approaches discussed by the European leaders before and after the Messina Conference, which marked the turning point in the process of European integration.

Rome, did not go very far, and they probably saved the EEC from severe criticism and grave tensions.

On the other hand, if one accepts that the EC's legitimacy arose from the demand for economic growth and free trade, it follows that once the free-trade goal was more or less accomplished and the EC authorities turned out to be unable to sustain growth and avoid unemployment, the EC's pursuit of goals beyond free trade became more vulnerable to criticism and the already fragile functional legitimacy of those policies became even weaker. Thus, once free trade was achieved and economic growth started to falter, the opportunity cost of eliminating undesirable activities (and possibly much of the EC structure itself) fell considerably.

A Survival Problem for the EEC

From a broader viewpoint, toward the end of the 1980s two issues had become apparent to the architects of the transnational European idea. First, intra-EEC trade liberalization had largely been achieved, and the remaining relevant trade issues hinged on the EEC's relationships with third parties rather than those among its members. Second, the difficulties met in the Uruguay Round negotiations indicated that other important elements of European common policy making were unacceptable on the world scene and would have to be abandoned, or at least diluted substantially, before long.

Having accomplished its primary original goals and having failed to achieve significant results in secondary areas, at the beginning of the 1990s the EEC could have dismantled much of its policy-making apparatus in a fairly short time. Of course, such retrenchment would not have ruled out keeping alive ad hoc committees designed to tackle specific issues of multilateral interest (such as transportation and transborder environmental pollution), in which any country might take part on a voluntary basis. In addition, actions might have been taken to establish monitoring bodies to enforce the agreed-upon rules of the game and to sanction agents or countries that violated such rules. But if such an approach had been adopted, resulting in an association more like the older Organization for European Economic Cooperation (OEEC), much of the European bureaucratic and political superstructure would have become redundant, with important repercussions for the related rent-seeking activities both in Brussels and in the member countries.

Put differently, at the turn of the decade the legitimacy of the original EEC goals was untarnished, but justification of its large and growing bureaucratic apparatus had become much more problematic. If the many highly paid politicians, bureaucrats, and rent-seeking groups involved in the EEC activities were to keep and enhance their privileges, a reformed and diminished Community represented a serious threat. As I have already argued, if those with an interest in the survival of the EEC had appealed to the public interest, they would have had little chance of success. In fact, Community leaders rationally chose to change the very scope of their organization and to commit them-

selves to serving specific interest groups rather than the welfare of the society as a whole. As the theory of collective action would predict, by doing so they succeeded in mobilizing strong, highly motivated interest groups that favored a new form of European integration against weak, fragmented coalitions that advocated cutbacks in European bureaucracies and the scope of their policies (Buchanan and Lee 1994, 222).

National Demands for a Federal Shield

The solution to the EEC survival problem came to the surface in the 1980s,[15] when most European national politicians came under attack from the electorate and revealed an increasing tendency to avoid responsibility for their actions. At that time, the traditional, domestic policy-making tools were not so popular as in the past. In particular, the redistribution of wealth through inflation was meeting increasingly firm opposition by the voters. Regulation and rent-seeking had contributed to reducing the rate of economic growth considerably, especially in a long-run perspective. Slow growth magnified the public's awareness of the inefficiencies of government intervention, yet the large amount and low "quality" of government intervention remained critical both for electoral success and to reward the rent-seeking activities among favored constituents. In order to maintain extensive rent-seeking without significant public opposition, a return to relatively rapid growth would have been necessary. But that would have required quick and effective deregulation in the labor market, a drastic reduction of deadweight losses, and possibly higher inflation (to make the adjustment of relative prices easier), a strategy that would have been politically dangerous because of opposition to inflation among significant strata of the population. Moreover, important interest groups would have fiercely resisted liberalization.

Consistent with the tenets of public choice, a second course of action was embraced, and the Maastricht Treaty was instrumental to it. By shifting some policy making from the national peripheries to the European center, the politicians augmented their opportunities to obfuscate the costs imposed on the rest of the population by narrow-interest transfers. This obfuscation, which has become known as the "shield effect" (Vaubel 1986), allowed national politicians to escape pressure from potentially disgruntled coalitions in their home countries. Hence, centralized policy making became the core of the European integration process, facilitating efforts by national politicians and top bureaucrats to channel transfers to specific groups.

15. A first draft of the EU project was passed by the European Parliament in 1984. As pointed out in Breton, Cassone, and Fraschini 1998, it emphasized the principle of subsidiarity, which was crucial to gaining acceptance of expanding intervention by the European authorities. From the institutional point of view, this change in attitude became embedded in the Single European Act in 1986, which according to Inman and Rubinfeld (1998, 15–16) marks the birth of the European model of centralized federalism. However, the principles of coordination, cooperation, and subsidiarity had appeared at the very beginning of postwar European integration. The crucial difference between 1957 and 1984/1992 is that in the Treaty of Rome the principle of subsidiarity was meant to delegitimize federal intervention (Meerhaeghe 1998, 239), whereas later the same principle was invoked to opposite effect.

In order to avoid being held responsible for rent-seeking, national policy makers had to make known that their hands were tied. The Maastricht Treaty served this purpose well.[16] The 1997 Stability Pact complemented it by preventing governments from adopting major countercyclical policies in the presence of negative shocks,[17] but not precluding transfers of resources from one country to another. Such transfers could be concealed under the cover of development or unemployment benefits or welfare support.[18] Of course, this arrangement does not necessarily mean that national politicians are going to be deprived of their power, because the Commissioners (and the Executive Board of the European Central Bank) are appointed by the political leaders of the member countries, to whom they are accountable. Thus, their activity was and remains monitored by national politicians and by the most powerful and best-organized interest groups. A telltale sign in this respect is the use that is being made of the principle of subsidiarity, which national governments now view as a tool to restrict Federal decision-making when such restriction is deemed necessary (Kersbergen and Verbeek 1994). True, the lack of sanctions against "undesirable" policies leaves the Commission and the ECB to some extent unaccountable for their actions; but that "slack" does not necessarily imply independence.[19]

From Rome to Maastricht Once More

Clearly, the idea of a European Union (and of an Economic and Monetary Union) differs from the original concept of a European Economic Community and even more from the preexisting organization (the OEEC), which had no supranational powers. Both the OEEC and the EEC conformed to the tradition of *The Federalist,* in which a federal authority recommends itself if it is "an effective umpire to competing national governments" (Breton, Cassone, and Fraschini 1998, 40). That umpiring service

16. According to this interpretation, the very fact that macroeconomic stabilization took place in the EU does not mean that the criteria described in the treaty forced governments to take action. Rather, such criteria provided a suitable justification for the adoption of measures that should have been taken anyway but would have been politically costly at home. And at the same time, the stabilization process created plenty of room for discretionary policies at the federal level.

17. The economic rationale for the Stability Pact is hard to find, however, as argued by Eichengreen and Wyplosz (1998). A political explanation would perhaps be more appropriate: satisfy public opinion in Germany and remove pressure from the ECB, in case the provisions established in the Maastricht Treaty do not carry enough credibility.

18. In 1997, 51 percent of the EU population were eligible for support under the so-called Social Funds (*Economist,* March 21, 1998, 37–38).

19. This observation also applies to central banking, for the notion that a European Central Banker would be more independent and act more commendably than a national one is logically flawed and not consistent with the evidence. The quality of central banking depends on the process whereby the central banker is appointed and on the preferences of those responsible for the appointment. Recent history demonstrates that central bankers in Europe have been able to obtain very low inflation even without a common currency, and that during the last forty years the very same institutions have pursued sometimes good, sometimes bad monetary policies. Their institutional links with other governmental bodies played little or no role.

represents the public good the authority produces. By enhancing factor mobility across Europe, the EEC gave substance to the notion of competition among institutions. Of course, that enhancement of factor mobility contrasts markedly with the EU ambition to harmonize legislation across member countries—a goal that, once realized, would deprive factor mobility of almost all practical consequence.

Once again, I do not deny that the Commission of the EEC—and, after 1967, of the EC—was already a player (as a policy maker) as well as an umpire. Its mediation service, however, was sufficiently beneficial to compensate for its questionable activity as a player until 1980s, when the European authorities recognized their urgent need for support from interest groups, both national and supranational.

One may wonder why such a blunt and hardly legitimate push toward centralization failed to arouse more forceful resistance, right from the start, all over the Continent. Among other reasons, the EMU evolved from a technical into a political issue only in the second half of the 1980s. Actually, many saw the alleged technical blessing of the EMU confirmed—and the euro functionally legitimized—both by the general fall in inflation and by the trend toward more balanced state budgets. In fact, the former took place in the late 1980s, the latter in the early 1990s. Neither had much to do with the euro. Inflation had started to fall when the EMS was still in place, and it continued falling or remained low all over the industrialized world, notably in countries that had nothing to do with the euro or the ECU (such as Switzerland, Japan, and the United States) and in countries that had explicitly ruled out joining the EMU in the near future (such as the United Kingdom and Sweden). Monetary policy improved in many so-called weak EU economies, thanks not to the EMS and the EMU but to free movement of capital, which allowed traders to get rid of the bad currencies and buy better ones.[20] Similar comments apply to the budgetary policies, which improved in the highly indebted countries mainly because of the increasing difficulty of financing their deficits. Once again, credit should go not to the euro but to free movement of capital. Indeed, the very fact that monetary and fiscal policies improved well before the common currency was introduced or the ECB had become operative suggests that political resolve and necessity were more influential than the euro or the EMU.

Finally, the Economic and Monetary Union came to symbolize centralized federalism only a short time ago, after domestic policy makers began to emphasize centralized monetary policy rather than the need for monetary coordination and stability.[21] Only in the past two or three years have policy makers been using—and in some cases abusing—the Federal "shield" to justify increased taxation or steps toward

20. Vaubel (1989) argues that the fight against inflation was actually more successful in the non-EMS countries of the OECD area. See also Fratianni and von Hagen (1992, chap. 5 on the EMS and chap. 8 on an extension to the EMU), which shows that the EMS had no built-in deflationary bias. Policy makers behaved as people wanted them to behave.

21. The notion of centralized monetary policy had a long tradition—and modest practical consequences—going back as far as the Treaty of Rome. See Fratianni and von Hagen 1992, chap. 2.

deregulation. Although it would be unreasonable to argue that the public-choice link between national and federal policy makers has now become entirely transparent to voters, people have not had much time to appreciate that a new, effectively centralized political and bureaucratic layer is in place and must be dealt with.

The Melting Down of the Hard Core

A third source of ambiguity concerns perceptions throughout Europe about the political consequences of the monetary union. Those perceptions have been far from homogeneous (Colombatto 1998). Some countries perceived political integration as a means to achieve Continental supremacy and world status, and accepted it as such. Once incorporated into a new federal organization, those countries hoped to emerge as much stronger contenders in the international community. Their leaders would have enhanced their own prestige and authority in the domains of ordinary policy making and law bargaining as well as their importance in a historical perspective, being the founding fathers of a new political entity with a crucial role in the world.

In other parts of the Union, support for the project came from those who regarded the EMU as a means of getting rid of their allegedly incompetent (national) political elites—Italy, for example, fit this description—and from those who viewed integration as a protective device to avoid less desirable scenarios. Certainly in Greece, Ireland, Spain, and Portugal the cost of staying "out" was assumed to be greater than the cost of being "in."

The Hard-Core Bloc

The group of countries known as the "hard core" corresponds by and large to the D-mark–French franc area and includes Germany, France, Austria, Belgium, Luxembourg, and the Netherlands. Although the region was not an optimum currency area, in the 1980s its leading members, France and Germany, shared two common resolves: the ambition to have greater economic and political weight in the international arena and the desire to run a strict monetary policy even in the presence of structural disequilibria. In pursuit of the first goal, more power had to be transferred to the European Community, so that France and Germany could add the economic weight of other EC countries to their own. In order for the second goal to be attained, the EMS needed to be replaced by the single currency. Because hegemonic decision-making processes were not considered acceptable (or enforceable) by most other EMS members, the EMS was actually weakening monetary policy in the hard-core countries and at the same time exposing them to what they saw as "competitive devaluations" by the weaker members.

In addition, the EMU project would have allowed France to bring German monetary policy under control and thereby resolve the well-known dilemma French policy makers had often confronted in recent decades.[22] The EMU project also would

permit Germany to revive its quest for a truly federalist Europe, which France and the U.K. had blocked in the 1970s but which German politicians never forgot.[23] In short, the hard-core economies put forward a project whereby the selected member countries could design and successfully launch policies without being fully accountable to the rest of the Union. The purpose of the European Monetary Union, and in particular of the Maastricht Treaty criteria, was therefore to shape this bloc and select the countries accordingly. The criteria for admission into the EMU were designed to be strict enough to exclude, almost automatically, the undesirable members, yet permissive enough to admit "friendly" countries if necessary.

The smaller hard-core economies mentioned previously had little choice but to join the new club led by Germany and France. By staying out they would have lost the possibility of bearing greater weight in the policy-making process to come. Moreover, by contributing to the creation of a powerful bloc within the European Union, such smaller hard-core economies would have a better chance to resist pressures to increase transfers to the benefit of other, possibly "weak," countries.

The Weak Countries

In the weak-bloc economies, the public at large had different reasons for not objecting to the EMU project. Hopes for better policy making were emotionally relevant, as mentioned earlier. But the fear of being left out and thereby losing decision-making powers in the areas of redistribution and regulation (harmonization) probably played a crucial role. In addition, tighter European integration was perceived as an opportunity to influence, lock in, and possibly increase monetary transfers for a long time to come. National politicians were also attracted to the EMU project because of the shield effect and because of the enhanced legitimacy they could acquire by gaining international prestige and recognition on behalf of their countries.

Thus, these allegedly weak countries perceived the Maastricht Treaty as a political pledge to create a tightly integrated policy-making European Union, rather than as a technical constraint. The benefit for the local policy makers was obvious; so was the cost of staying out.

More Ambiguities

The preceding paragraphs make clear that ambiguities could easily have developed around two sets of issues. On the one hand, the hard-core countries allowed some

22. In short, the trade-off was the following. The French could follow a relatively loose monetary policy, providing short-term alleviation of unemployment but losing prestige as the franc depreciated vis-à-vis the D-mark, or they could adhere to German monetary standards, sacrificing consensus on the domestic political scene. See also Vaubel 1991 and Feldstein 1997.

23. Twenty years earlier, Giscard d'Estaing and Schmidt had had something else in mind. In contrast to what was proposed in the Delors Report adopted at the Madrid Summit in 1989, the outline put forward by the two leaders at the end of the 1960s did not anticipate the creation of a political superstructure.

discretion in defining the Maastricht criteria, sharing the belief that the weak bloc would have scarcely any chance to take advantage of it. In turn, members of the weak bloc had little incentive to clarify matters, for at the time their bargaining power was relatively feeble. Indeed, the political elites in the weak bloc tended to emphasize the elements of flexibility contained in the Maastricht Treaty and to postpone clarifications to a more favorable moment, so as to minimize the possibility of being excluded after premature confrontation.

On the other hand, the EMU project was also very vague about transfers. From the hard-core viewpoint, that vagueness meant that transfers were not to be included in the EMU deal. More realistically, the weak-bloc members clearly perceived that countries outside the Union would be penalized when negotiating about the size and direction of transfers.

In the mid-1990s, when the public began to question some of the initial assumptions of the project, and when its unsettled ambiguities were finally exposed, the original scheme of the EMU as a restricted club within the European Union threatened to fall apart. The convergence of the weak bloc toward the critical values imposed by the Maastricht Treaty had taken place much faster and much more successfully than expected. Several hard-core countries had run into problems and had been obliged to make use of "creative accounting" to qualify for membership in their own creation. Furthermore, global liberalization had decreased the appeal of having a large bargaining power and reduced the relevance of regulation on a national or regional basis, and at the same time had increased the perceived cost of centralization and monopoly in policy making.

More generally, the hard-core countries began to appreciate that the stage was set: they would have to fight hard to oppose resource transfers, in amounts at least as generous as in the past, that promised them not much in return. Paradoxically, this outlook brought little comfort to the (former) weak bloc. For the future beneficiaries might be not today's weak EMU countries but tomorrow's new members—say, from Central and Eastern Europe. Those members would be poor enough to qualify for the transfers *and* large enough to decisively sway crucial votes in the decision-making process of the future EU.

Concluding Conjectures

In the preceding analysis I have emphasized that the birth of the euro is characterized by lack of enthusiasm, weak legitimacy, plenty of ambiguity. It does not make much sense from the economic viewpoint, and it raises many difficult questions with respect to politics and policy making. Managing the euro will certainly prove much harder than introducing it.

Nevertheless, the pessimistic interpretation I have presented does not necessarily imply that crisis could break out at any moment. In fact, the short-term outlook may

be better than the "fundamentals" of the EMU seem to suggest. The very fact that the project rests on fairly shaky foundations might well induce potential rent-seekers to act with unusual caution and restraint. Good policy making in the short term can bring about greater rent-seeking opportunities in the long run, once the legitimacy of the EMU is firmly established. In other words, the very fact that the European authorities have failed to generate great public ardor for what many consider a fundamentally important undertaking in European political and economic history has also made them aware that now is not the most propitious time to defend special interests or to engage in ordinary rent-seeking activities.

Surely, the Commission will remain vulnerable to national politicians who prevail on the EU authorities to carry out expansionary policies, especially under conditions of slow economic growth. The federal government, like any other government, will seek to avoid blame for slow growth and high unemployment.[24] Yet the interaction between federal and national powers is going to be delicate. Their failure to satisfy ex ante national expectations about regulation (and other things) has somewhat changed the rules of the game for federal politicians and bureaucrats. As a result, priorities are now being reassessed, both in Brussels and in most EMU countries. Until recently the goal was simply to perpetuate rent-seeking opportunities by shifting responsibilities to Brussels. Today, more attention is being devoted to creating a satisfactory balance between the European authorities and the local (national) policy makers. The former are eager to obtain credibility and ultimately legitimacy. The latter seem to be less concerned about being adequately shielded by Brussels and more worried about the amount of decision-making power being devolved to, or seized by, the federal authorities.

Therefore, although the long-run outcome of the EMU project will necessarily depend on the features of federal policy making, in the shorter run the balance of power between local and federal governments will probably be decisive. If so, the competitive-government structure described by Albert Breton (1996) may apply, at least temporarily; and the public interest may be pursued more effectively than in the past. In other words, the interaction between domestic and federal authorities may induce the latter to pay more attention to the public interest in order to acquire legitimacy.

This possibility is strongest with respect to domestic European matters, about which the competition with the national politicians is more intense. The rules of the game may be different on the international scene, where the competitors are not agents striving to acquire credit from the European electorate. It is therefore plausible to imagine that future regulatory and rent-seeking efforts in the EMU will be focused on matters such as international trade policies, finance and banking regulation, and safety and

24. In contrast, the primary concern of the ECB is not high growth, but low inflation.

environmental legislation. Past experience provides some support for this conjecture. Although the EU authorities have never reneged on their free-trade principles, many of their actions have been inspired by notions of "fairness" and "sustainability."

Hence, the debate about the behavior of the European Union, and of the EMU in particular, in the short to medium term should be analyzed from a revised perspective. The emphasis should not be on the extent to which the federal authorities will (or will not) be able to enhance social welfare by following a free-market approach. Rather, it should be on the speed with which the balance of power will shift from the national to the federal authorities and on the attitude of the EU on the international scene. The first issue is relevant because that shift is a precondition for effective centralized policy making, and it affects the nature of the response to the strains provoked by the single currency in a non-optimum currency area. The international role of the EU is important because it could turn out to be a source of legitimacy, compensating at least partially for the EU's shortfall of legitimacy within Europe.

If the perceived fragility of the EMU venture delays the onset of "reformed" rent-seeking, as I have conjectured it might, that delay could save the Union from public outcry. Should the authorities rush to engage in myopic rent-seeking efforts, then the whole federal project will be more likely to come under severe attack.

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