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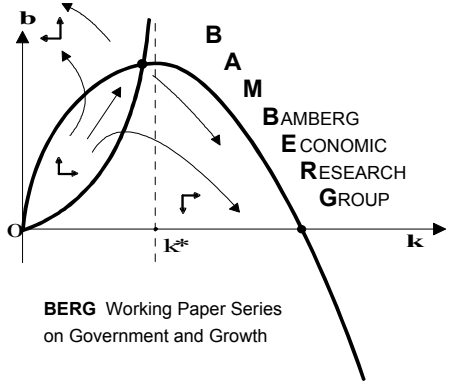

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Public Debt and the Future of the European Union's Stability and Growth Pact

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Abstract

Monetary policy and fiscal policy are connected in various ways. This is why the adoption of the Euro as a common European currency has been accompanied by the setup of the European Union's Stability and Growth Pact, a framework for the coordination of the EU countries' fiscal policies. In this paper, we provide a short overview of the SGP's history of origins and the degree to which the EU Member States adhered to it. Further, we analyse what effects public debt and public deficits have and whether, after all, public debt should be limited in one way or the other. Along these lines, the case for budgetary policy coordination in the special context of the Economic and Monetary Union is presented. After looking at the current SGP framework, we shed light on its main shortcomings and present various reform proposals, all of which are critically questioned. Finally, we present a case for a more flexible country-by-country approach to the interpretation of the deficit criterion (based on some simple algebra).

Keywords:
Stability and Growth Pact (SGP), public debt, public deficits, fiscal policy, policy coordination, Maastricht criteria

JEL Classification: E61, E62, H6, D62, H87

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Public Debt and the Future of the European Union's Stability and Growth Pact

1 Introduction

Monetary policy and fiscal policy are connected in various ways. This is why the adoption of the Euro as a common European currency has been accompanied by the setup of the EU's Stability and Growth Pact (SGP), a framework for the EU countries' fiscal policies. Since the introduction of a common currency in the EU, the SGP aims at avoiding excessive public deficits of single Member States. This is deemed to be necessary because if the budgetary policy of one Member State of the Economic and Monetary Union (EMU) is too lax, this may adversely affect other Member States (e.g. via increasing interest rates), and thus be harmful to the general confidence in the economic stability of the Euro zone. Sound public finances are often considered to be a prerequisite for price stability and a cautious use of monetary policy instruments by the respective central bank (in EMU: the European Central Bank (ECB)).

Already in 1992, EU countries set down the so-called convergence criteria (also known as the "Maastricht criteria") for Euro zone membership. These criteria included sound public finances, stable exchange rates and low interest rates. At that time, the (former) German government (led by the Christian Democrats) worried that some countries (especially from Southern Europe, pejoratively named "Club Med" at that time) would fail to watch their finances once part of the Euro zone. In December 1996, on an initiative taken by the former German Minister of Finance Theo Waigel, the Dublin European Council reached political agreement on the main ingredients of what was to become the SGP. This paved the way for the formal adoption of the SGP at the Amsterdam European Council in June 1997: the Stability and Growth Pact Resolution was formally adopted, setting up a system of sanctions for Member States failing to keep budget deficits below three percent of GDP for three years in a row. This way, the Maastricht criteria's validity has been extended to serve as the foundation pillars of an EMU-wide measure of precaution aiming at budgetary discipline (EUROPEAN COMMISSION, 2002, pp. 18-19).

As it is widely known, various countries have not adhered to the SGP's rules from the outset. As early as 1998, Italy had difficulties to keep its budget deficit below 3 per cent of its GDP. In 2001, Portugal had to revise the originally reported figure of 2.2 per cent – at the end of 2001, its deficit amounted to 4.4

per cent. Most recently, Germany and France have had public deficits above the 3 per cent limit for three consecutive years (2002, 2003 and 2004). Accordingly (as set out in Article 104 of the Treaty establishing the European Community), Excessive Deficit Procedures (EDPs) have been launched against both countries. Yet, both are likely to breach the 3 per cent ceiling in 2005 again; Italy, the Netherlands, Portugal and other countries are likely to follow suit (EUROPEAN COMMISSION, 2004).

One of the central aims of the SGP, a "medium term budgetary position of close to balance or in surplus", has been continuously ignored or at least postponed by many countries. The most recent spectacular case of disrespect of the SGP rules comes from Greece, where the deselected socialist Pasok government is accused of having systematically adjusted downward by roughly 2 percentage points the public deficit in order to (artificially) keep it below the 3 per cent limit. If the accusations prove to be correct, Greece has continuously breached the 3 per cent ceiling from 2000 to 2003 (when the deficit amounted to 4.6 per cent of GDP) and is likely to do so again (5.7 per cent are forecasted for 2004) Greece would then never have played by the SGP's rules since its existence. It is by now a matter of common knowledge that Greece has not even adhered to the Maastricht criteria in 1998 and 1999 – the reference years for its 2001 Euro entry (HAGELÜKEN, 2004a, 2004b and 2004c; SCHLÖTZER, 2004).

Obviously the SGP does not work as originally intended. Since its installation it has therefore been subject to controversial academic and political discussion. The main points of criticism include the arbitrariness of the deficit and debt criteria, the SGP's focus on short-term goals, its asymmetric design, the fact that it disregards the aggregate fiscal stance, the weak enforcement mechanisms, and its limited flexibility, just to name a few. Consequently, the academic literature has brought forward many reform proposals ranging from completely new designs to adaptations within the existing regulation. However, the central flaw of most proposals is their lack of thorough economic reasoning independent from the existing political compromise. In this light, most articles implicitly assume either that some kind of instrument for fiscal discipline – for whatever reason – is necessary in a monetary union (here EMU), that there are economic reasons for debt/deficit limitation, or that the existing framework is basically appropriate (for the reason of its mere existence) and that only slight changes will make it the optimal fiscal instrument. One central aim of this paper is to critically question whether, after all, public debt should be limited somehow, i.e. whether there is a *raison d'être* for the SGP *per se*. And if there is, which rules are efficient and stable?

The remainder of this paper is organised as follows. In Chapter 2, we analyse what effects public debt and public deficits have and whether, after all, public debt should be limited. Along these lines, the case for budgetary policy coordination in the special context of the Economic and Monetary Union is outlined. In Chapter 3, we investigate the current SGP framework. In Chapters 4 and 5, we shed light on its main shortcomings and present various reform proposals, all of which are critically questioned. In Chapter 6, we present a case for a more flexible country-by-country approach to the interpretation of the deficit criterion, based on some simple algebra. Chapter 7 concludes.

2 Public Debt and Fiscal Policy in Closed and Open Economies

2.1 Public Debt in a Closed Economy

Hardly any another topic in the field of economics has been discussed as controversially as the role of public debt. Already in the middle of the 18th century DAVID HUME (1777) stated that "either the nation must destroy public credit or public credit will destroy the nation." In strong contrast, CARL DIETZEL stated roughly one hundred years later (1855) that "public borrowing is … the lever for powerful economic progress and thus … the Archimedean standpoint, that lifts the world off its hinges."[1] And another one hundred years later, in the 20th century, the situation is hardly different, since economic and fiscal policy is interchangeably dominated by Keynesian and by monetarist/neoclassical orientation. If one thinks about rules for limiting public deficits such as the SGP, it makes sense to analyse the implications of public borrowing first.

In this context, one has to pay attention to the fact that public debt impact analyses are always carried out as differential incidence. This means that with given expenditures, the impacts of alternative financing instruments have to be compared with each other. Otherwise there is the danger of batting public debt like in shadow boxing, while the actual opponent is public spending.

Distributive Effects of Public Debt

Public borrowing leads to income redistribution between the interest tax payers and those who receive interest payments. If the creditors of the public sector and the interest tax payers are not the same economic agents, then public debt leads

[1] Own translation.

– *ceteris paribus* – to an increased inequality of the personal income distribution. This argument is often heard and it even appears plausible. The fallacy here however is that the incidence of public borrowing is confounded with that of wealth formation.

This argument becomes even more absurd, when people talk of "pledging the future of our grandchildren."[2] In reality, future generations are the recipients of interest payments *as well as* those who pay the taxes needed to this end: we owe is to ourselves.

If there are specific distributive effects of public debt, then they are to be found in the change of the functional income distribution and in the change of the personal income distribution resulting thereof. And – as emphasized already at the beginning – these can only be measured in terms of a differential incidence. If we assume that an alternative financing through taxes puts a heavier burden on current consumption than bond financing, then this pattern – which in the literature is erroneously called "debt illusion" – is the trigger mechanism for a change in the functional income distribution and therefore implicitly in the personal income distribution. As a consequence "poor" households e.g. with a high time preference rate will benefit from bond financing, since the present value of future interest tax obligations will then be lower than today's income loss caused by an alternative financing through taxes.

Hence, we detect that public debt has intertemporal distributive impacts, that these impacts differ from those of tax financing and that by no means their assessment has to be more negative than that of tax financing.

If we then accept the principle of intertemporal equivalence, which – as a "pay-as-you-use-principle" – is based on the idea that those who benefit from public expenditures should also participate in their financing, then we have an indicator for the correct extent of public debt. Clearly, taking this principle as an indicator is a normative statement. In sum, we can say with LORENZ VON STEIN (1871) that "a government without debts either asks too much of the presence or does too little for the future."[3]

Allocative Effects of Public Debt

From what has been said above, it follows that it is problematic to think of public debt in income terms as a postponement of the burden to the future. A

[2] The media in fact often report correspondingly.
[3] Own translation.

postponement of the burden to the future can only result from a *ceteris paribus* lower real capital formation (due to public debt), which reduces tomorrow's consumption possibilities. But this argumentation against public debt, too, suffers from the fallacy that a higher real capital stock in the future *per se* is seen as utility-increasing. Taken to an extreme, this argumentation would read: it is utility-maximizing to consume nothing at all today but everything tomorrow. This makes clear that the truth has to lie somewhere in-between. In other words, there must be an optimal intertemporal flow of utility and consumption.

In the literature on public finance (e.g. WENZEL, 1992a; WENZEL and WREDE, 1993), the conditions for the existence of stable consumption-maximizing growth equilibria with positive public debt have been derived. These results make clear that it is also false to say that today's debt is tomorrow's tax, since debt and GDP can grow in lockstep without reducing government's room for manoeuvre and without necessarily leading to a reduction of government's indebtedness.

The analysis of public debt in the framework of growth models also shows that each statement about the "correct" level of public debt hinges on technological and behavioural prevailing circumstances. In particular, the production elasticities of the macroeconomic production function, the population's propensity to save as well as the proportion of public investment expenditures must be mentioned. Even the Article 115 of German basic law (Grundgesetz), which in Germany limits the extent of yearly public borrowing to the level of expenditures for public investment, has to be assessed critically under these assumptions.

There is even another group of efficiency arguments in favour of debt financed public expenditure. Their foundation stems from the excess burden of alternative tax financing. It is well-known that – with the exception of lump-sum taxes – all taxes lead to efficiency losses, which even increase quadratically with the tax rate. Thus, even if public borrowing leads to future interest and repayment obligations, the payments could occur with an extended maturity date and with lower tax rates, and would hence be efficiency-increasing

Six Theses Regarding Public Debt in a Closed Economy

Along the lines of our reasoning in the previous paragraphs, we can summarize our arguments regarding public debt in a closed economy by proposing six theses:

1. When analysing the impacts of public debt, it is economically absurd to start from the assumption that the sum of the discounted deficits has to equal zero.
2. Today's public debt is not necessarily tomorrow's taxes.
3. The problem is rather an "expenditure trap" than a "debt trap".
4. Deficits have to be "grown out" rather than "saved out".
5. The debate on public debt is reminiscent of shadow boxing: public debt is battered, while the actual opponent is public spending.
6. Public borrowing functions like an inter-generation contract. Abrogations and unlasting contract durations are not pareto-superior.

2.2 Public Debt and Fiscal Policy in Economic and Monetary Union

This section will examine fiscal policy in a monetary union (in particular EMU) under three aspects: In which way national fiscal policy influences other EMU members; how joining EMU changes the incentives to run deficits and, in close relation to that, how the risk of default and the necessity for bail-outs change. On these grounds, the last subsections investigate the cases for policy coordination and deficit limitations.

Externalities and Spill-overs

There is general agreement that fiscal policy under a fixed exchange rate regime and centralised monetary policy has spill-over effects (externalities) affecting the other countries in a monetary union.[4] Usually three channels for such externalities are mentioned: intra EMU trade, the Euro area wide interest rate, and the Euro exchange rate (BRUNILA, 2002, p. 3; BUTI and SAPIR, 2004, p. 139). Before summarizing the usual points, this section will start with identifying one often ignored adverse effect through the trade channel: imported inflation and thereof resulting deteriorations of the other countries' current accounts.

[4] A categorization of different types of spill-overs has been proposed by von Hagen and Mundschenk (2001). They differentiate between 1) 'horizontal spill-overs', where one country's policy directly affects the national economy of another and 2) effects on 'club goods', where one country's policy affects a commonly shared variable or institution (Euro exchange rate, Euro price level or the common market). To avoid confusion, this text only uses the synonyms 'spill-overs' and 'externalities'.

Trade Channel and Imported Inflation

For the purpose of illustration it is necessary to differentiate prices of tradables (p^T) and non-tradables (p^N) in the home country (H) and its trading partners (F). Fiscal expansion in the home country (H) drives up domestic prices if no complete crowding-out occurs (p_H^N and p_H^T rise). Under a fixed exchange rate regime, the trading partners of the expanding country must import inflation through the more expensive tradables (p_F^T rises). More expensive imports lower the utility level of F because real wages decrease for all individuals who buy imports. With the overall inflation rate of country i being

$$\pi_i = \tau_i \, p_i^T + (1-\tau_i) \, p_i^N \, ,$$

where τ is the share of tradables in overall consumption ($0 < \tau < 1$), it follows that in the short run $\pi_H > \pi_F$. This is equivalent to a real appreciation of H's currency. In the short run, when the MARSHALL-LERNER condition[5] does not hold, this will improve H's and deteriorate the other countries' trade balances in real terms. Normally, the opposite effect would set in as soon as agents react to the new relative prices for tradables (the MARSHALL-LERNER condition holds in the longer run). But the crucial point here is that two adaptation processes occur simultaneously, creating an unfavourable outcome for the foreign countries. While foreign importers start to react to the real appreciation, wages adapt to the more expensive imports. This raises p_F^N and implies that eventually $\pi_H = \pi_F$. Thus, the real appreciation is corrected, and therefore consumers in F continue to buy tradables. In the end, H's trading partners are left with higher inflation and a temporarily deteriorated current account.

Independent from such adverse effects due to simultaneous adaptation, another externality also works through the trade channel: If demand and income are fuelled due to fiscal expansion in one country, the demand for imports (absorption) from the other EMU countries will (in the long run) rise as well. This positive externality partly offsets other negative spill-overs.

[5] The Marshall-Lerner condition shows the circumstances that lead to an improvement or a worsening of a country's balance of payments if the exchange rate of the respective country's currency changes. It states that "provided that the sum of the price elasticity of the demand coefficients for exports and imports is greater than one, then a fall in the exchange rate will reduce a deficit and a rise will reduce a surplus." If the Marshall-Lerner condition is not met and the sum of the price elasticity of the demand for exports and imports is less than one, then a fall in the exchange rate will bring about a worsening of the balance of payments.

Interest Rate Channel

For the above given reasons, fiscal expansion has inflationary effects. But in EMU, inflation can only be tackled by the ECB at the supranational level. Depending on the size of the country and the amount of additional public spending, the ECB – following an inflation target of less than 2 per cent – will be forced to raise interest rates for the whole Euro area. EMU-wide growth will slow down. This is the commonly mentioned externality through the interest rate channel. But in addition to the negative growth effects, higher interest rates also pose a threat to the sustainability of other countries' government debt. In the long run, the higher interest rates might cause the public debt burden to balloon. Some economists argue that interest rate externalities can be ignored because "Europe is fully integrated in the world's financial markets so that any one country's borrowing is unlikely to make much of an impression on world and European interest rates" (BALDWIN and WYPLOSZ, 2003, p. 386). But this argumentation ignores a crucial point. Admittedly, countries like Ireland or Luxemburg are unlikely to influence the World's or Europe's interest rates. Even Germany's fiscal policy might not force the *Federal Reserve Bank* to change its policy. But the ECB is one of the three institutions whose monetary policy does influence world economics and it is therefore watched with great attention. Thus, it is enough if one EMU country influences the ECB's interest rate policy to largely affect the world economy.

Euro Exchange Rate Channel

The third channel is the Euro exchange rate. As interest rates are likely to rise due to fiscal expansion, demand for the Euro will increase and an appreciation occurs. While the effect on the exchange rate is initially positive, excessive fiscal expansion may cause financial fragility of the Euro through unsustainable debt. However, in the long run, the appreciation worsens trade balances with non-Euro countries of all EMU Member States (through the trade channel).

In sum, it is hard to identify the sign of the overall effect because negative and positive externalities exist. Empirical evidence on the issue is ambivalent but still waits for exhaustive inquiry (BRUNILA, 2002, p. 3). While externalities through the trade channel may indeed be positive, effects of excessive fiscal expansion on inflation and the Euro exchange rate are likely to be undesirable. This view will be taken throughout this paper.

Changed Incentives for Deficits and Budgetary Action

Entering EMU changes two fundamental economic conditions: firstly, the exchange rates with other EMU countries are fixed and secondly, interest rate and monetary policy by the central bank is not cut-to-measure for each country, but set at the supranational level for the whole Euro area by the ECB.[6] This leads to crucial restrictions as well as new tasks for national fiscal policy.

It is common knowledge that in EMU, fiscal policy is the only instrument remaining in national hands to adjust to country-specific shocks. But in EMU, such asymmetric shocks may even be amplified through the following mechanism: with a centralised interest rate policy inflation variations across countries determine the real cost of investment. Together with the BALASSA-SAMUELSON effect[7] this implies growth-hampering high real interest rates in slow growing countries and lower real interest rates in booming countries. Thus, debt financed fiscal action becomes highly relevant to react to asymmetric downturns. In addition to that, EMU creates several other (dis-)incentives for its increased use.

Fiscal Expansion Has Stronger Effects

While in the open single economy case the positive effects of extra spending are partly or completely crowded out through higher interest rates and an appreciation of the domestic currency, in EMU an individual appreciation of the currency cannot occur. The consequence is that the wanted effect on the domestic economy of a fiscal expansion on the domestic economy is stronger (exports do not decrease). The enhanced effectiveness of fiscal expansion states an incentive for making increased use of the instrument.

Passing on the Burden

In the single economy case, fiscal expansion is likely to partly crowd out investment. In EMU the same fiscal expansion will cause a less strong rise of

[6] Note that a separate analysis of fiscal policy externalities under flexible exchange rates and *national* monetary policy could be made, but is not necessary here. It is sufficient here to remark that closely interlinked economies (even without a common central bank) are likely to be exposed to similar externalities due to often highly correlated exchange rates and intensive trade relations.

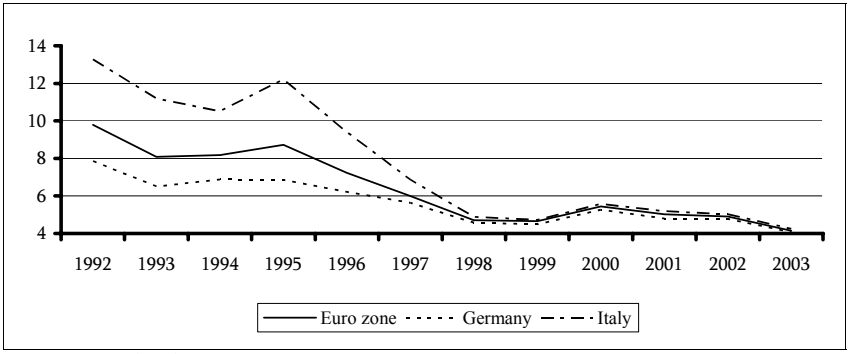
[7] According to the Balassa-Samuelson effect (as presented in the seminal contributions by Balassa (1964) and Samuelson (1964)), productivity growth in the open (tradable goods) sector usually exceeds that in the sheltered (non-tradable goods) sector. Given that wages are expected to be roughly the same across those two sectors, faster productivity growth in the open sector leads to an increase of wages in all sectors, thus pushing up the relative prices of non-tradable goods. Therefore, if productivity growth in one country (e.g. Hungary) outpaces that in the other (e.g. Germany), overall inflation will be higher in the former (i.e. in Hungary).

the Euro interest rate. This is because (with respect to the inflation target) *ceteris paribus* a slight rise of the interest rate in the whole EMU can be seen as equivalent to a large one in only one country. Thus, the crowding-out effects are mitigated in the expanding country at the expense of the other EMU countries' growth. Hence, the inherent danger of moral hazard in a monetary union with central monetary policy becomes obvious because countries can pass on some of the pains of fiscal expansion to the other Member States.

Shared Risk

The fact that governments with relatively fragile finances face lower risk premiums after joining EMU states a third incentive. While yields (representing the risk premium) on e.g. Italian government bonds were substantially higher than on e.g. Germany's before 1998, the differentials have narrowed since they are all denoted in Euro. This can be seen in Figure 1.

Figure 1: *Annual averages of 10-year government bond yields (reflecting risk premiums) in per cent*



Source: Eurostat (2004).

This has two reasons: firstly, financial markets are increasingly integrated. Secondly, while the risk premium of a single economy government bond reflects a) the risk of the government to default and b) the risk of the national currency to devalue, the risk premium of a country in a monetary union only represents the former of the two aspects if a bail-out is implicitly assured. Italy benefits because its country-individual default risk premium was well above the EU-average before monetary union, but since 1998 its public debt issuance has become relatively cheap.

A Tightened Budget Constraint

Joining a monetary union also creates disincentives for excessive spending. For many countries joining EMU meant forgoing two very handy instruments to mitigate the real debt burden: surprise-inflation (by lowering interest rates) and issuing bonds to the national central bank. The former lies exclusively in the hands of the ECB. However, the ECB is unlikely to make use of it because it adheres to a strict inflation (and money stock) target and bases its interest rate policy decisions on the whole Euro area. The latter is ruled out by Art. 104 of the Treaty establishing the European Community (EC Treaty) (EUROPEAN COMMUNITIES, 2002).

> **Art. 104 (1) EC Treaty:** Overdraft facilities or any other type of credit facility with the ECB or with the central banks of the Member States […] in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.

This regulation clearly bans any form of monetary financing of fiscal deficits and thus prevents immediate inflationary policy actions. Hence, the budget constraint of governments is tightened through EMU.

Thus, the question whether EMU enhances or worsens fiscal discipline is not trivial and quite ambiguous.[8] Some empirical evidence shows that deficits of countries in a monetary union tend to be lower than those of countries that are not part of a monetary union (VAN ROMPUY, ABRAHAM and HEREMANS, 1991). However, sample sizes are small and political influences and other special economic conditions manifold so that any generalisations should be interpreted carefully.

Fiscal Coordination in Economic and Monetary Union[9]

The Case for Coordination

The fact that in EMU fiscal policy externalities exist calls for (some form of) fiscal policy coordination. Counter-cyclical discretionary fiscal policy can be

[8] Wyplosz (1991) gives a good overview.

[9] The literature often uses "coordination" as an umbrella-term for peer review, dialogue and information exchange as well as joint policy action (see European Commission (2002), p. 3).

used to illustrate this.[10] Suppose that business cycles of two EMU members are synchronised and fiscal expansion has positive externalities. If both countries ignored their policies' spill-overs, both would take action appropriate for an independent economy. In sum, the expansion will be too strong. One aspect, which is usually forgotten in this context, is that the overreaction will be additionally intensified, because under fixed exchange rates fiscal expansion has stronger effects on the domestic economy even without spill-overs from another country.

In contrast, if both countries take the positive externality into account they are likely to wait for each others' action to do the job for them (free-riding behaviour). In this case, overall fiscal action will be too low. Similarly, uncoordinated fiscal action with asynchronised business cycles will also lead to undesirable results. The discretionary action in one country will further fuel the boom of the other. Alternatively, expenditure cuts in the booming country will worsen the crisis of the badly performing country.

Now, if the two governments coordinate their fiscal actions, the optimal level of discretionary spending can be realised if the external effects can be estimated correctly. This has two positive consequences: the shock will be smoothened optimally (consumption smoothing); and the aggregate deficit can be limited to the lowest possible level (no unnecessary 'excess debt').

This latter aspect is particularly important. Because uncoordinated fiscal policy over-stimulates growth, the Euro interest rates would need to be raised which in turn appreciates the Euro. Such intensified volatility of the business cycle bears severe risks for a financial crisis in presence of the accumulated excess debt. Thus, uncoordinated fiscal intervention can destabilise EMU because debt and volatility unnecessarily increase.[11]

[10] The reasoning presented here follows Baldwin and Wyplosz (2003, p. 385).

[11] Besides the arguments in favour, there are several against coordination: firstly, governmental decision processes to launch a spending campaign or reduce taxes in a recession often take as long as the baisse lasts; such lags would be substantially prolonged if discretionary spending decisions had to be coordinated with other governments or institutions (Brunila, 2002, p. 7). Secondly, a "high variance of economic structures, institutions and economic situations across member countries would make coordination of discretionary fiscal policy actions extremely complex" (Brunila, 2002, p. 8). Therefore, the transaction costs, which arise when each government delivers information on national and regional practices, structures and conditions to the central authority, would play a significant role. To exhaustively assess which of the stated factors prevails the other, more reliable empirical evidence would be necessary. Whether coordination of discretionary fiscal policy is desirable largely depends on how spill-overs are estimated. Moreover, it is important to take into account to which degree spending action shall be coordinated. For example, EMU-wide planning will pose greater obstacles than simply informing other governments in advance.

3 The European Union's Stability and Growth Pact

As we have shown in the previous parts of this paper, fiscal policy (in the form of expenditure policy or tax policy) and public debt have an influence on relevant economic variables of the Euro area such as e.g. price stability or the growth dynamics. Hence, there is a need for close and binding coordination mechanisms, i.e. a multilateral surveillance of the different EMU countries' fiscal policies. This is why the EU's Stability and Growth Pact (SGP) and the accompanying EDP have been brought to life.

The SGP aims at avoiding excessive public deficits in the Euro zone. In order to avoid that a too lax budgetary policy of an EMU Member State, the SGP is supposed to ensure sound public finances in EMU.

The legal basis of the SGP can be found in the EC Treaty itself (EUROPEAN COMMUNITIES, 2002a), but also in a "Resolution of the European Council on the Stability and Growth Pact" (AMSTERDAM EUROPEAN COUNCIL, 1997), as well as in two Regulations of the Council of the European Union: one is "Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies" (COUNCIL OF THE EUROPEAN UNION, 1997a), the other is "Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure" (COUNCIL OF THE EUROPEAN UNION, 1997b).

3.1 The Legal Bases of the Stability and Growth Pact

The Treaty Establishing the European Community

The Treaty establishing the European Community (EC Treaty) itself (EUROPEAN COMMUNITIES, 2002) is an important legal basis of the SGP: the Member States are committed to "sound public finances" (Art. 4 (3)) and they "shall avoid excessive government deficits" (Art. 104 (1)). According to Art. 104 (2), the European Commission is supposed to examine "whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value". Moreover, the Commission monitors "whether the ratio of government debt to gross domestic product exceeds a reference value". In a Protocol annexed to the Treaty, these reference values are specified: a threshold of 3 per cent for the public deficit to GDP criterion and a threshold of 60 per cent for the public debt to GDP value – the famous Maastricht criteria.

In Art. 104 of the EC Treaty, the EDP is laid down, too. This procedure is a central element of the SGP and stands for the legally binding character of the Pact, which provides for sanctioning mechanisms in case of non-compliance. We shed some more light on the EDP below.

The SGP was formally adopted at the Amsterdam European Council in June 1997, when the Stability and Growth Pact Resolution (AMSTERDAM EUROPEAN COUNCIL, 1997) was officially adopted, setting up a system of sanctions for Member States failing to keep budget deficits below three percent of GDP for three years in a row. This way, the Maastricht criteria's validity has been extended to make up the foundation pillars of an EMU-wide precaution aiming at budgetary discipline.

Resolution of the European Council on the Stability and Growth Pact

In the "Resolution of the European Council on the Stability and Growth Pact" (AMSTERDAM EUROPEAN COUNCIL, 1997), the Member States "commit themselves to respect the medium-term budgetary objective of close to balance or in surplus set out in their stability or convergence programmes". In addition to this, the EMU Member States "will correct excessive deficits as quickly as possible after their emergence; this correction should be completed no later than the year following the identification of the excessive deficit".

As with EU law in general, the European Commission is supposed to be the "guardian of the Treaties" in the case of the SGP, too: in the Resolution, it is obliged to "exercise its right of initiative under the Treaty in a manner that facilitates the strict, timely and effective functioning of the Stability and Growth pact". Moreover, the Commission is assigned the task to guarantee „the effective functioning of the early warning system and the rapid launch and strict application of the excessive deficit procedure".

The Council, too, is an important actor in the SGP framework: it is e.g. "invited always to impose sanctions if a participating Member State fails to take the necessary steps to bring the excessive deficit situation to an end as recommended by the Council".

Council Regulation (EC) No 1466/97

On 7 July 1997, the Council passed the "Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the

surveillance and coordination of economic policies" (COUNCIL OF THE EUROPEAN UNION, 1997a). Art. 1 of this Resolution "sets out the rules covering the content, the submission, the examination and the monitoring of stability programmes and convergence programmes as part of multilateral surveillance by the Council so as to prevent, at an early stage, the occurrence of excessive general government deficits". In Art. 3, the EMU Member States are obliged to submit on a regular basis so-called stability programmes. These stability programmes shall contain "the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective for the general government surplus/deficit and the expected path of the general government debt ratio".

Among other tasks, the Council in Art. 5 of the Resolution is charged with the examination – on the basis of Commission recommendations (and in the framework of multilateral surveillance) – "whether the medium-term budget objective in the stability programme provides for a safety margin to ensure the avoidance of an excessive deficit". According to Art. 6, the Council is assigned the task to issue an early warning "in order to prevent the occurrence of an excessive deficit, address, in accordance with Article 103 (4), a recommendation to the Member State concerned to take the necessary adjustment measures."

Council Regulation (EC) No 1467/97

Also on 7 July 1997, the Council passed "Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure" (COUNCIL OF THE EUROPEAN UNION, 1997b). The central aim of this Regulation is to avoid excessive public deficits "and, if they occur, to further their prompt correction". Moreover, the Resolution clarifies various details concerning the EDP, e.g. the Commission's policy when setting up its country reports: the Commission shall "consider an excess over the reference value resulting from a severe economic downturn to be exceptional only if there is an annual fall of real GDP of at least 2 %", so that sanctions can be refrained from.

3.2 The Stability Programmes

The SGP is based on a mixture of prevention and correction. Annually, the so-called stability programmes have to be submitted by each government in order to foster sound budgets and regular surveillance – that's the SGP's main preventive element. Only when the need arises, the core of the EDP with its

speeding up sanctioning mechanisms is activated (corrective part of the SGP, see below) (EUROPEAN COMMISSION, 2002a, p. 22).

In this Chapter, we shortly present the concept of the stability programmes, which are central to the SGP, since they represent the rule, whereas the EDP – which is much more present in the public discussion and in the media – is (or better: should be) only the exception, because – as mentioned above – it is only activated when a Member State has effectively broken the rules.

In Stage 2 of EMU, the countries that prepared for adopting the Euro had to submit convergence programmes, in which they had to prove compliance with the Maastricht criteria. The SGP builds on this and introduced annual stability programmes (as "successors" of the convergence programmes) for the Euro area countries. This way, the Maastricht criteria's validity has been extended to make up the foundation pillars of an EMU-wide precaution aiming at budgetary discipline. Hence, the entry rules (especially the well-known threshold of 3 per cent for the public deficit to GDP criterion and the threshold of 60 per cent for the public debt to GDP value) have become the permanent fiscal rules in EMU. Those EU countries that have not (yet) adopted the Euro continue to submit convergence programmes (EUROPEAN COMMISSION, 2002a, p. 20).

The legal basis of the stability programmes is the aforementioned Council Regulation (EC) No 1466/97 (COUNCIL OF THE EUROPEAN UNION, 1997a), whose core element is the medium-term budgetary objective of close to balance or in surplus. What the SGP essentially seems to aim at are sound underlying budgetary positions in cyclically-adjusted terms in order to create room for manoeuvre in cyclical downturns (without breaching the 3 per cent threshold). This is why the European Commission requires that "cyclically-adjusted balances should continue to be used, in addition to nominal balances, as a tool when assessing the budgetary position" (EUROPEAN COMMISSION, 2002a, p. 20).

3.3 The Excessive Deficit Procedure

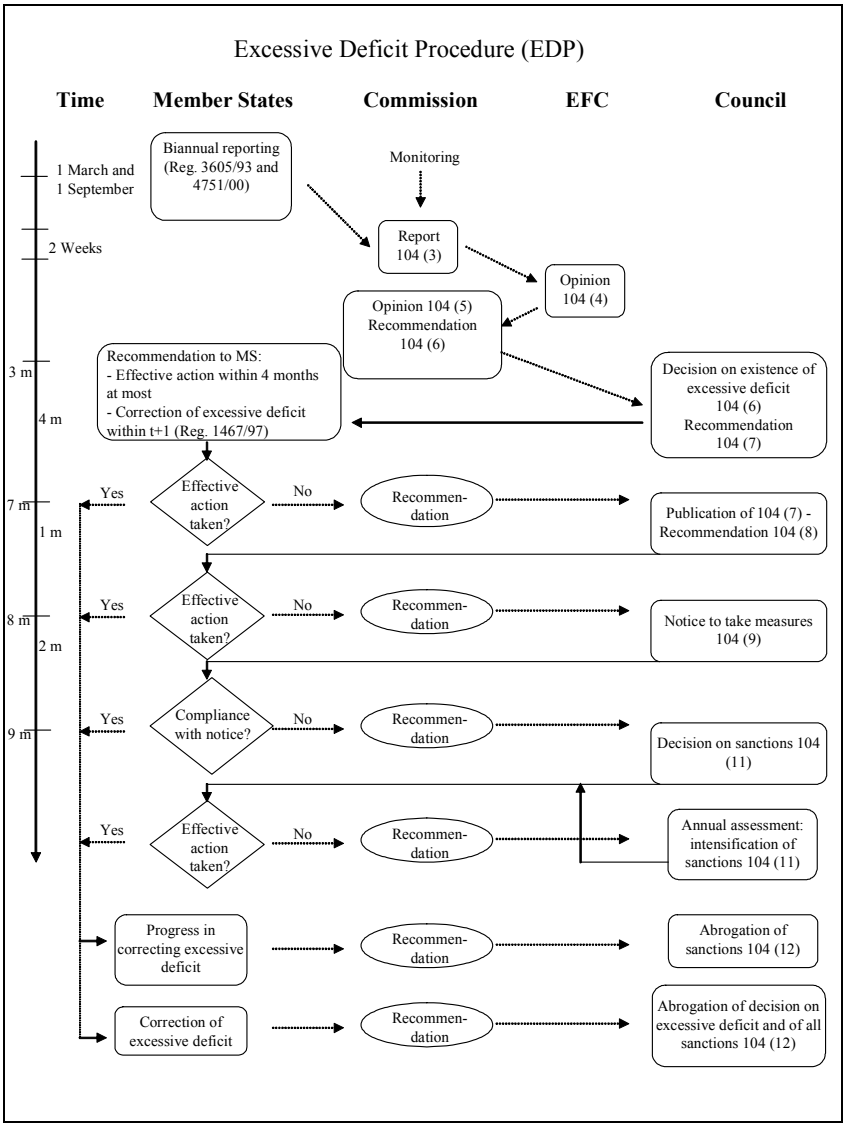
The EDP with its speeding up sanctioning mechanisms is the SGP's central corrective mechanism, which is only activated when multilateral surveillance in the framework of the stability programmes has failed and when a Member State has effectively broken the rules (i.e. breached the 3 per cent deficit ceiling).

The main legal basis of the EDP is the EC Treaty's Art. 104 (European Communities, 2002). This is the core legal basis of the EDP and the procedure that is most prominently present in the public discussion and the media (just

think of the current EDPs against Germany and France). Therefore we schematically illustrate its functioning in Figure 2.

As can be clearly seen from Figure 2, the entire procedure is based on Member States' reporting and Commission monitoring. Twice a year, the Member States submit national reports on recent and prospective public finance data to the Commission. If the Commission sees a risk of an excessive deficit or a risk that the requirements concerning the deficit or debt criterion are not satisfied, it will trigger the EDP proper by drafting a report. To that report Member States respond to the Commission via an opinion endorsed by the Economic and Financial Committee (EFC). If the Commission keeps its view, it sends a recommendation to the Council. The Council then has to decide whether an excessive deficit exists in the country/countries in question. The Council will then take the pivotal decision – a decision that must be based on a thorough overall assessment, which may differ from the Commission's opinion. If the Council decides that an excessive deficit exists, the EDP follows a recurrent pattern: the Community gives incentives to correct the situation and then assesses the Member States' response. The incentives are strengthened if the assessment is negative. Ultimately sanctions are imposed. Here, the Council Regulation (EC) No 1467/97 (COUNCIL OF THE EUROPEAN UNION, 1997b, see above) starts to play a role. It is another important legal basis of the EDP. Its central aim is to speed up and clarify the EDP's implementation. It is much more specific on the sanctions than the Treaty, but for the sake of brevity we will not go into the details of the sanctioning mechanism here. Only when there is effective progress in correcting the excessive deficit, the sanctions can be abrogated (EUROPEAN COMMISSION, 2002a, p. 25).

Figure 2: *The Excessive Deficit Procedure*



Source: European Commission (2002, p. 27).

As stated above, the EDP is laid down in Art. 104 of the EC Treaty. A pivotal element of Art. 104 is paragraph 2, according to which the European

Commission is supposed to examine "whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value". Moreover, the Commission monitors "whether the ratio of government debt to gross domestic product exceeds a reference value". As mentioned above, these reference values are specified in a Protocol annexed to the Treaty: a threshold of 3 per cent for the public deficit to GDP criterion and a threshold of 60 per cent for the public debt to GDP value – the famous Maastricht criteria. In Chapter 6 of this paper, we will question to what extent these criteria are arbitrary.

4 The Main Shortcomings of the Stability and Growth Pact

4.1 The Stability and Growth Pact's Limited Flexibility: "One Size Fits All" Cannot Work

One of the central allegations is that the "one size fits all" design of the SGP limits necessary flexibility to react to country-specific shocks while fiscal policy is the only major economic policy instrument remaining in national hands. This is even more so in the context of EU Eastern enlargement: the new Member States from Central and Eastern Europe have high public deficits, and even higher public investment needs. While the SGP's "one size fits all" design was hardly appropriate in an EU with 15 Member States, it is even less so in the EU-25. Such a general fiscal rule cannot be economically meaningful, since it does not take into account the differences in prevailing circumstances (think of German reunification for example), propensities to save, risk aversions etc. – all of which differ from Member State to Member State.

4.2 Public Investment Deserves a Special Treatment

The SGP's current framework does not take into account the quality of public finances: is there a public deficit because of excessive public consumption or because of useful public investment? The SGP does not incorporate a "golden rule", which would exclude needed public investment projects (with longer-term pay-offs) from the calculation of the deficit ratio. This may essentially imply a disincentive to launch useful public investment projects, since in the SGP's logic, public investment increases the public deficit.[12] Public investment however is crucial for an economy and a society, since it replaces (lacking)

[12] Balassone and Franco (2000) show in a two period model that the introduction of a deficit ceiling (such as the SGP's 3 per cent limit) can imply a reduction in public investment, i.e. in the public sector's contribution to capital accumulation.

private investment in many cases where there are high costs in the medium to short run (and private investors therefore choose to not get involved), but benefits accrue only much later (think of education or infrastructure investment). This way, the public sector not only contributes to the building and passing on of capital stock, but also yields a significant social return via public investment (BUTI, EIJFFINGER, and FRANCO, 2003, p. 11).

Generally speaking, an investment project implies *future* returns and normally entails a considerable gap between current revenues and current expenditures. The costs involved should be distributed over time as the returns accrue. However, the SGP does not allow amortization of investment expenditures by governments. Thus, it would be important to remove constraints on public investment in the EU for two reasons: firstly, in many EMU countries public investment has been falling since the mid-1970s (net investment being now practically zero in Germany, Italy, Belgium and Austria). Secondly, room for public investment would be particularly important for the new EU Member States from Central and Eastern Europe (BUTI, EIJFFINGER, and FRANCO, 2003, p. 11; BLANCHARD and GIAVAZZI, 2003, p. 4).

4.3 The "Close to Balance or in Surplus" Rule: Unfavourable Impacts for Intergenerational Equity

By providing education, public infrastructure etc. through public investment, the public sector makes an important contribution to the building and passing on of capital stock. "Passing on" refers to handing accumulated capital down to the next generation. Public investment thus contributes to intergenerational equity, in the sense of transfers between generations, i.e. an inter-generation contract.

The European Commission uses the interpretation that budgets must be "close to balance or in surplus" over the cycle (see e.g. EUROPEAN COMMISSION, 2002a, p. 20). This essentially means that the Commission aims at increasing the use of cyclically adjusted balances (CAB) in budgetary surveillance (EUROPEAN COMMISSION, 2004a, pp. 78 ff.).[13] However, this implicitly assumes that there is

[13] In any given period t, the CAB is obtained by subtracting c_t (the cyclical component) from the actual budget balance to GDP ratio, b_t:

$$CAB_t = b_t - c_t = \frac{B_t}{Y_t} - \varepsilon * \frac{Y_t^R - Y_t^{RP}}{Y_t^{RP}},$$

where B_t is the nominal balance and Y_t is nominal GDP. c_t, the cyclical component, consists of two elements: firstly ε, which is a "budgetary sensitivity" parameter, indicating how the budget reacts to the economy's cyclical position. Secondly, a measure of that cyclical position: the output gap, defined as the percentage difference between actual Y_t^R and potential Y_t^{RP} (European Commission, 2004a, p. 79).

a *raison d'être* for budgets to be "close to balance or in surplus" over the cycle. Is there? This rule boils down to envisaging a zero deficit in general equilibrium. Using some simple algebra, it can be shown that this will eventually drive the public debt ratio (as defined by B/Y) to zero, given continuous positive output growth.[14] This is surely not consistent with optimal growth and intergenerational equity.

As mentioned above, WENZEL (1992a) and WENZEL and WREDE (1993) have shown that there are stable consumption-maximizing growth equilibria with positive public debt, implying that debt and GDP can grow in lockstep without reducing government's room for manoeuvre. Furthermore, let us remember that there are other good reasons for preventing public debt from disappearing: as argued before, public debt can be a vehicle for transfers between generations, or can come in the form of public investment projects with a high rate of social return (BLANCHARD and GIAVAZZI, 2003, p. 2).

Moreover, in the history of economic thought, hardly any topic has been as controversial as the pros and cons of public debt and deficits (see e.g. WENZEL, 1992b). In 1997 for example, a proposed balanced-budget amendment to the Federal Constitution of the United States was strongly opposed by leading US economists (like ARROW, SAMUELSON, SOLOW etc.) as being unsound and unnecessary. These economists emphasised that "[t]here is no need to put the nation in an economic strait-jacket."[15] We know today that there was indeed no need for a fiscal strait-jacket. Shortly after, the US federal budget ran a surplus, though the Constitution had not been amended in the way proposed.[16]

4.4 The Stability and Growth Pact Neglects the Optimal Intertemporal Allocation

In the basic SOLOW growth model setting (SOLOW, 1956), the golden rule of capital accumulation as an optimal rule depends not only on technology, but also on the population's propensity to save. If the people of a country are particularly risk averse, they might well save too much, i.e. more than required by the golden

[14] Compare the Proposition in Chapter 6.

[15] At the Allied Social Sciences Association (ASSA) Conference in New Orleans in January 1997, a statement of Robert Eisner, Robert M. Solow, and James Tobin circulated, using this formulation.

[16] The United States, too, have a history of repeated attempts to control budget deficits: already in 1985, the Gramm-Rudman-Holling Act was intended to control escalating deficits by giving the US comptroller general the right to order spending cuts if the President and Congress did not reduce the deficit. However, that bill was ultimately declared unconstitutional. A 1990 revision of the Act changed its focus from deficit reduction to spending control. In 1996, a law establishing a limited presidential line-item veto was passed by Congress, but in 1998 it was ruled unconstitutional, too.

rule. As a result, there is an over-accumulation of capital, which is not consumption-maximizing, neither today nor in the future. In this case, the public sector has to borrow (i.e. accumulate public debt) in order to withdraw private savings, reduce the over-accumulation of capital and thus move the economy in the optimal steady state. WENZEL (1994) has shown that public borrowing in this context has a greater influence on capital intensity and capital formation than tax financing. The problem with the SGP is that it does not take account of these optimal intertemporal allocation aspects, since it limits public debt and public deficits regardless of over-accumulation of capital in an economy and regardless of the potential need for the public sector to intervene via borrowing.

4.5 The Stability and Growth Pact is Short-Term Focused, the Deficit Rule Manipulable

Another of the SGP's flaws is that focusing on the annual deficit does not ensure that countries envisage reaching any long-term target value (e.g. 60 per cent), or the long-term reduction of structural deficits. Far more likely are accounting tricks and one-off measures towards the end of the fiscal year for political window dressing. Such actions do not only torpedo the rules, but they also create an incentive for intransparency and inaccuracies in the public books. The best example of this is the recent case of the deselected socialist Pasok government in Greece, which is accused of having systematically adjusted downward the public deficit by roughly 2 percentage points in order to (artificially) keep it below the 3 per cent limit.[17]

Thus, while the 60 per cent value lacks a real economic justification (ultimately, it is an arbitrary target), the Pact does not even provide any incentive for reducing an existing higher debt-per-GDP ratio in the long run. Before 1997 there was at least the motivation of meeting the Maastricht criteria to join EMU. The fact that the SGP puts so much emphasis on the 3 per cent limit is problematic insofar as the interpretation of the deficit threshold depends on the different countries' debt ratios (which, as a matter of fact, are very heterogeneous across EMU members): highly indebted countries should respect closer limits to public deficits than less indebted ones (as will be shown in Chapter 6).

[17] Greece obviously has continuously breached the 3 per cent ceiling from 2000 through 2003 (when the deficit amounted to 4.6 per cent of GDP, compared to 5.7 per cent which are expected for 2004 (!)), i.e. Greece has never respected the SGP's rules so far (see also Chapter 1).

The SGP's short-term character also implies that it categorically discourages large reforms that require temporal deficits to ensure long-term sustainability (e.g. pension reforms). Focusing on yearly deficit ratios, the Pact neglects foreseeable contingent liabilities of the public budget, especially the obligation to maintain the pension and social systems (given the demographic challenges of rapidly ageing societies), which most governments have not made provisions for so far.

4.6 The Stability and Growth Pact's Asymmetric Design and Procyclical Bias

Furthermore, the SGP is alleged to be asymmetric on two accounts. Firstly (and maybe most importantly), the problem is the SGP's procyclical bias. This means that the SGP "is essentially focused on budgetary discipline during cyclical downturns rather than upswings. While an excessive deficit is sanctioned, there are no effective enforcement mechanisms to ensure appropriate budgetary behaviour and to run even sizeable budget surpluses during cyclical peaks" (BRUNILA, 2002, p. 10). Secondly, while it discourages excess spending through sanctions and fines, compliance or out-performance is not rewarded. In this light it has often been described as "all sticks and no carrots" (BEAN, 1998, p. 106).

A good example of this is Germany's and France's budgetary policy in 1999 and 2000, when – in spite of a cyclical upswing – they did not consolidate their budgets, but reduced taxes (in a financially unsound way) and even increased public expenditure. Due to the procyclical bias of the SGP, the two *poids lourds* of EMU failed to reduce their structural deficits and consequently breached the 3 per cent threshold as soon as the cyclical downturn started in 2001.

4.7 The Stability and Growth Pact Disregards the Aggregate Fiscal Stance

Further criticism refers to the fact that the SGP "disregards the aggregate fiscal stance" and therefore, at the aggregate level "[a]n inappropriate fiscal stance may occur without formally violating the rules" (BUTI, EIJFFINGER, and FRANCO, 2003, p. 11), since the result of aggregating the single national fiscal stances does not necessarily generate the optimal EMU fiscal stance. But with a common currency and common monetary policy the aggregate stance would actually be the decisive variable to ensure the right policy mix[18], especially with

[18] Also the European Commission refers to the aggregate fiscal stance in the context of ensuring the right policy mix. See European Commission (2004, p. 20).

respect to exchange rate stability and overall financial integrity of the Euro zone. Also the German Council of Economic Experts ("Sachverständigenrat") complains about the fact that the SGP puts so much emphasis on monitoring deficits on the national level, whereas the extent of the macroeconomically much more relevant aggregate fiscal deficit of the Euro area as a whole is hardly known to anybody (SACHVERSTÄNDIGENRAT, 2004, p. 784). The obvious solution to this problem is either policy coordination with all the complexities outlined above or to define an EMU-wide fiscal stance. In this context, the introduction of a budgetary deficit for the Euro area as a whole has been thought about.

4.8 Unreliable Enforcement Mechanisms and Partisan Application

Another flaw of the SGP – this time more a problem of political effectiveness than of lacking economic rationality – has led to the awkward situation that at the beginning of 2004 the highest central organ of the EU (the European Commission) has filed a complaint against one of the highest political bodies in national hands, the Council of Economics and Finance Ministers of the European Union (ECOFIN) before the highest European legislative body (the European Court of Justice) – the reason being that in November 2003 ECOFIN decided against the strict application of the SGP deficit procedure in the cases of Germany and France. While this event has often been over-dramatised to be the end of the Pact, it surely illuminates one central weakness: the rules are subject to substantial political discretion (so called partisan application) and there is a lack of credibility and effectiveness of the enforcement mechanisms. It is no wonder that ECOFIN stopped the procedure because any of its members may be the victim one day. A judge asked to decide over his own punishment has hardly ever proven to be very strict. Hence, ECOFIN has far too much discretion and limits the role of the European Commission as a "guardian of the Treaties". This weakens the concept of peer pressure (or peer review) as an effective means of policy coordination. Consequently, it has been proposed several times that an automatism would be more desirable because it would eliminate any political influence on a purely economic issue (see e.g. PEFFEKOVEN, 2004, p. 11).

4.9 Difficult Enforcement in Federally Organised Countries

In many (especially federally organised) EU Member States, the central government budget represents only part of the overall public spending. This is the case e.g. in the Federal Republic of Germany, where the central government

budget ("Bundeshaushalt") accounts for approximately only half of the overall public deficit, whereas the subnational entities' budgets (mostly "Länderhaushalte") account for the other half. Although the responsibility to comply with the SGP lies with the German federal government, the latter can hardly control the deficits in the subnational budgets.

The so-called "national stability pacts" which have been brought to life in some EU Member States due to this problem often lack effective enforcement mechanisms and credible sanctioning, and often there are problems of coordination failure.

For example, the German Stability Pact has been adopted as a cooperative procedure intended to contribute to the achievement of compliance with the Maastricht criteria. Yet, there is no effective supervisory body, the supervisory procedure is not adequate, and there are no sanctions that could be imposed (WISSENSCHAFTLICHER BEIRAT BEIM BUNDESMINISTERIUM DER FINANZEN, 2004, p. 25). The SGP however should not have entered into force without a sufficient guarantee that the national stability pacts ensure its functioning on the European level. However it is fair to say that a recently installed commission in Germany tries to reform the German federalist system and in this context it has been working on making the SGP become part of the German Basic Law (Grundgesetz), so that also subnational levels of government can be made accountable for public debt and deficit sanctions.

5 Some Reform Proposals Revisited

5.1 A Review of the Reform Proposals Presented by the European Commission

Not only academia, but also the European Commission itself has come up with some reform proposals concerning the SGP. In a Communication to Council and to the European Parliament (EUROPEAN COMMISSION, 2002b), the Commission has outlined proposals aiming mainly at more flexibility in the SGP's interpretation as well as an improved implementation of the Pact.

In spite of these reform proposals, two years later (in 2004) the intermittent experiences with the SGP's implementation since 2002 have been disappointing in many cases: in November 2003, France and Germany managed to stop the EDP that had been started against them by ECOFIN – completely ignoring the entire rules-based approach "designed to spread German fiscal rigour across

Europe" (PARKER, 2003, p. 2).[19] The Commission reacted and filed a complaint against ECOFIN before the European Court of Justice. Germany and France again have public deficits above the 3 per cent limit in 2004 and are likely to breach the ceiling in 2005, too. Generally speaking, about half of the EMU countries (including Italy, the Netherlands, Portugal etc.) are likely to breach the ceiling in 2004 and 2005 (EUROPEAN COMMISSION, 2004a). All of this again highlights the weaknesses of the SGP and explains why the Commission felt a strong need to outline new detailed and concrete reform proposals in September 2004 (EUROPEAN COMMISSION, 2004b). Recognizing the "need to act" in order to "save" the SGP, the Commission (under the new Economic and Monetary Affairs Commissioner Joaquín Almunia) this time was seemingly more committed to present real reforms, partly however also giving in to the criticism brought up by some Member States such as Germany and France.

At the beginning of its September 2004 Communication, the EUROPEAN COMMISSION (2004b, p. 3) admits that "over the past years, tensions have accumulated in the application of the SGP, leading to a loss of credibility and ownership … the application of the framework has highlighted further possibilities to improve it." In this context, the Commission recognizes that the EU-25 is much more heterogeneous than the "old" EU of 15 Member States. Therefore, the essential message from the Commission proposals is to allow for more flexibility in the SGP's implementation and "to better cater for differences in economic situations across the EU" (EUROPEAN COMMISSION, 2004b, p. 2).

The Commission's revised approach is characterized by substantially four main elements (EUROPEAN COMMISSION, 2004b, pp. 3-7):

1. *Putting more focus on public debt and sustainability when budgetary positions are monitored*. This essentially means that more focus should be placed on the debt criterion (the 60 per cent limit) and the Treaty provision of a "satisfactory pace" of debt reduction. The "satisfactory pace" shall depend on country-specific current growth conditions, a provision that clearly would be an element of enhanced flexibility. All of this at least approaches the logic of the Proposition we present in Chapter 6 of this paper, i.e. that both the debt ratio and the growth rate of a country matter when the deficit target is to be defined.

[19] This event has often been called "the Pact's death". The day after, the Financial Times headline read: "Ministers conduct late-night burial for EU fiscal framework" (Parker, 2003, p. 2).

2. *Taking better into account country-specific circumstances when setting the medium-term objective of budgets "close to balance or in surplus"*. Whereas, in contrast to the argumentation in this paper (see Chapter 4.3), the "close to balance or in surplus" rule is not categorically questioned, the Commission at least admits that as a general and undifferentiated rule for all EMU countries, it is not economically meaningful: "[U]niform objectives for all countries do not appear appropriate and lack economic rationale" (EUROPEAN COMMISSION, 2004b, p. 4).

3. *Considering economic circumstances and developments when implementing the EDP*. This proposal affects two dimensions: Firstly, when a country suffers from prolonged periods of sluggish growth, there could be an "exceptional circumstances clause" preventing that country from being considered in excessive deficit. Secondly, with the EDP already having been started, there should be different adjustment paths and paces to correct the excessive deficit, depending on the economic conditions and debt levels in the respective countries, i.e. "the SGP should better take into account the economic conditions and fundamentals of a Member State breaching the 3% reference value" (EUROPEAN COMMISSION, 2004b, p. 5). Importantly, the Commission admits that "[o]ne-size-fits-all deadlines for the correction of excessive deficits have basic limitations because they do not permit distinguishing between countries with different cyclical developments and with different debt levels" (EUROPEAN COMMISSION, 2004b, p. 5). This proposal should be welcomed, since it refrains from the overly rigid implementation of the EDP, which lacks an economic rationale. Clearly, most pertinent to this (very) Commission proposal were the continuous demands of EDP-persecuted EMU countries Germany and France, who claim that their growth has recently been constantly sluggish and that an overly rigid EDP would have procyclical adverse effects.

4. *Ensuring earlier actions to correct budgetary developments deemed inadequate*. An interesting claim lodged by the Commission in this context is its quest for the capacity to issue "early warnings" directly. This idea has even found its way into the new EU Constitution.[20] Clearly, such an automatism would reduce the degree of political discretion/partisan

[20] The new EU Constitution has been signed by the European Heads of State and Government in Rome on 29 October 2004, but it has yet to be approved by national parliaments and national referenda.

application involved and thus improve the SGP's implementation (see also Chapter 4.8) (EUROPEAN COMMISSION, 2004b, pp. 3-6 and 8).

On 15 November 2004, the ECOFIN Council met in order to discuss the Commission's SGP reform proposals. In accordance with the Commission, the Economics and Finance Ministers emphasized the need to avoid pro-cyclical policies, to make the debt criterion more operational and to take structural reforms into account (COUNCIL OF THE EUROPEAN UNION, 2004, p. 7). To be more precise, a number of Member States (especially from Central and Eastern Europe) ask for a special treatment for example of pension reforms (given the impact of pension payments on debt and deficit ratios). Some Member States (such as France) would like to exclude spending on research and development from the public deficit, whereas others again (notably Germany) would like to be rewarded for their net payments into the EU budget by being given the right to exclude those payments from the public deficit (HAGELÜKEN, 2004d, p. 21). The European Commission gave a first clear sign of its "new" approach and its more flexible interpretation of the SGP on 14 December 2004, when it decided to take no further steps against Germany and France under the EDP (EUROPEAN COMMISSION, 2004c).

5.2 A Review of Some Reform Proposals Presented in the Literature

Clearly, most of the reform proposals presented in the literature try to remedy at least some of the main deficiencies of the SGP analysed in Chapter 4. From the following paragraphs, the connection with Chapter 4 will be very obvious. In this paper, we only present some very central and economically intuitive reform proposals. Moreover, we critically review and question those proposals. For a comprehensive overview of many SGP reform proposals see e.g. BUTI, EIJFFINGER, and FRANCO (2003) or EEAG (2003).

Incorporating a Golden Rule

To ensure pay-as-you-use equity and encourage public investment, it has been proposed to integrate a golden rule into the SGP. This is a particularly important reform proposal, since all over Europe, economists and policymakers would understandably like to see public spending contribute more to growth and employment (and thus e.g. to the EU's Lisbon agenda of economic reforms and growth). Hence, public spending would have to be allocated more to investment purposes and less to purely consumptive and redistributive action. Only then can

EU Member States grow out of their indebtedness. Therefore, however, public investment must not be discouraged as it currently is by the prevailing SGP rules.

BLANCHARD and GIAVAZZI (pp. 1-7) show that envisaging a zero deficit in general equilibrium, as the "close to balance or in surplus rule" implies, will eventually drive public debt to zero. This is surely not consistent with growth optimality and intergenerational equity (see Chapter 4.3). The authors then show that, when interest payments and depreciation are included and net investments are excluded from the budget (just as it is common practice in private sector accounting), running a zero deficit in general equilibrium will eventually drive public debt to the same level as the public capital stock. This result ensures that fiscal stabilisers could work freely, that public investment would not be limited[21] but even encouraged and that over the cycle, net borrowing would equal the growth of the public capital stock. Moreover, if public debt converged to the public capital stock, the latter would be the target value instead of an arbitrary 60 per cent limit.

However, not all public investment projects pay off and yield the cash flow that a careful cost-benefit analysis requires them to. Moreover, excluding public investment from the deficit calculation might open new doors to hidden deficits and create incentives for "creative accounting": what kind of public expenditure can actually be called "public investment"? Such a golden rule might lead to many expenditure categories being declared "investments" even instead of a rather consumptive character, and thus to increased budgetary intransparency (EEAG, 2003, p. 59).

Expenditure Rules Instead of Deficit Limits

The discussion about limiting deficits and the appropriateness of debt versus tax financing is somewhat blurred insofar as it does not question why, after all, debt or tax financing is necessary. In other words, the underlying public expenditure which has to be financed somehow is the core as well as the basis of the problem. Some authors therefore propose to define expenditure rules rather than limit deficits. Such proposals imply that only the expenditure side of governments is bound, independent from collected tax revenues. The argument goes that the income side can hardly be controlled in any case and therefore,

[21] For empirical evidence that especially in the run-up to EMU public investment has been cut more drastically than expenditure see e.g. De Haan, Sturm, and Sikken (1996), and Balassone and Franco (2000).

expenditure rules would ensure higher compliance with fiscal limitation. Moreover, such expenditure rules might be easier to understand and communicate to the public than say a "cyclically adjusted balanced budget". Hence, it would be easier for the public to hold governments accountable for not complying with the budgetary rules.

However, when recalling the different reasons for limiting government deficits, expenditure rules obviously fail to meet a whole set of them. Expenditure rules do not limit the scope of the public deficit and thus do not take adequate account of those deficits' effects on other EMU members. In other words, they do not prevent spill-over effects, i.e. they do not refer to those fiscal variables that actually generate negative externalities. Also, government tasks can often be funded on the income as well as the expenditure side. As a result, accounting tricks and a tendency towards tax rather than expenditure policies would occur and undermine effective control. Finally, it would be problematic to introduce expenditure rules in a multinational context (such as EMU): uniform spending rules would impose homogeneous preferences to countries that are politically heterogeneous, while with country-specific rules, EMU-wide enforcement would be difficult (PEFFEKOVEN, 2004, pp. 9-10; BUTI, EIJFFINGER, and FRANCO, 2003, p. 16).

Defining a Budgetary Target for the Euro Zone as a Whole

In Chapter 4.7, we have shown that the SGP neglects the aggregate fiscal stance in EMU, which would actually be the decisive variable to ensure the right policy mix, since only the *aggregate* fiscal stance de facto enters the ECB's reaction function as an argument. In the literature, the idea to define an EMU-wide fiscal stance has been brought up. In this context, the introduction of a Euro zone stability programme and thus the idea of a budgetary deficit target for the Euro area as a whole have been thought about. In this case, a target would be set for the entire Euro area and then be shared between the Member States. Hence, the target (e.g. the 3 per cent limit) would only apply to the average deficit of the Euro zone, whereas some Member States would be allowed to have larger deficits, given that there are others with deficits below the target value (BUTI, EIJFFINGER, and FRANCO, 2003, pp. 18-19).

The most problematic aspect with this reform idea is the allocation of "deficit shares". Obviously a bureaucratic allocation (e.g. imposed by some EU institution) would be highly controversial. CASELLA (2001) suggests a system of tradable deficit permits (TDPs) as an alternative to a political/bureaucratic

allocation mechanism. After choosing an aggregate target for the Euro zone and an initial distribution of TDPs, the Member States could start to trade the deficit rights. In the case of a country-specific asymmetric shock Member State A e.g. could buy TDPs from Member State B in order to conduct stabilisation policy, if B has a budgetary surplus (or a deficit below the target value). However, a TDP system would be confronted with three major problems: firstly, in order to allow for efficient tradability, the deficits of the various Member States have to be perfect substitutes, i.e. they have to generate the same externalities. This is hardly the case, since the Member States differ with respect to size, indebtedness etc. Secondly, the efficiency of the TDP market depends on how competitive that market is. This is problematic in the case of very few market participants as in the case of EMU (currently 12). Thirdly, the problem of the initial distribution of TDPs would still have to be solved. "Objective" criteria such as GDP, population etc. would lead to strongly diverging allocations (BUTI, EIJFFINGER, and FRANCO, 2003, pp. 19-20).

Delegating Fiscal Policy to a Central Institution

In light of the problem of partisan application and the unsatisfying implementation of the SGP in the recent past, (quite far-reaching) reform proposals have been put forward to attribute the responsibility for the EU Member States' budgetary policy framework to a central and independent institution or committee. This would be a major step towards depoliticising fiscal surveillance in EMU. The questions asked by many contributors are precisely: If European monetary policy has been delegated to an independent central bank (the ECB), why is fiscal policy still decided in drawn-out parliamentary processes at the national level? Should we not learn lessons for fiscal policy decision-making from the independent institutions in the field of monetary policy (EEAG, 2003, p. 68)?

Clearly, papers and articles on this issue differ with respect to the terminologies for such a body. Like EEAG (2003, pp. 68-73), we will refer to it as a fiscal policy committee (FPC). Much more importantly, the contributions in the literature differ with respect to which competencies and decisions should be delegated to such an FPC. BLINDER (1997) e.g. goes as far as letting the FPC decide over the tax structure of Member States. Others (e.g. EICHENGREEN, VON HAGEN, and HARDEN, 1995) favour to delegate only the determination of the appropriate debt issuance (the decision about a so-called "debt change limit") in order to withdraw this fundamental decision from political influence. Most

contributions however limit themselves to attribute only pure stabilisation policy tasks to the FPC (EEAG, 2003, pp. 68-69).

The most obvious objection to the delegation of fiscal policy tasks to an FPC is that unelected technocrats would have the discretion to take very important political decisions, and thus that the delegation idea would not be compatible with democratic decision-making. Clearly, this problem can only be solved if the FPC is subject to democratic accountability. Moreover, given that in EMU fiscal policy is the only major policy instrument remaining in national hands, it is very unlikely that the Member States are willing to give in to the idea of delegating powers to an FPC. Furthermore, the centralisation of (at least part of the) fiscal competencies in EMU would hardly be compatible with the subsidiarity principle that the EU is keen on continuously emphasizing and that is part of the EC Treaty (e.g. in Art. 5) (see EUROPEAN COMMUNITIES, 2002). Hence, as far-reaching as these reform proposals are, their practical implementation is rather unrealistic.

6 A Contribution to the Reform Discussion: The Case for a More Flexible Country-by-Country Approach

As is often the case with numerical thresholds, the Maastricht criteria seem to be quite arbitrary at first glance. This is to a large extent true – but not completely: when the Maastricht version of the EC Treaty was negotiated, average public debt in the EU amounted to roughly 60 per cent of GDP. The average deficit ratio however was fairly above the 3 per cent level. Yet, the deficit ratio can be derived from stabilising the debt ratio at 60 per cent of GDP, if an average nominal GDP growth rate of 5 per cent is assumed across EMU Member States, as the following Proposition shows.

Proposition: In the long-run equilibrium (steady state), the quotient of the deficit to GDP ratio and the debt to GDP ratio *(d/b)* equals the sum of the real growth rate of GDP $g(Y^r)$ and the inflation rate π.

Proof: With public debt B and nominal (real) GDP Y (Y^r), for the growth rate g with $\dot{B} \equiv dB/dt$ it holds that

$$\begin{aligned} g(B/Y) &= g(B)-g(Y) \\ &= \dot{B}/B-g(Y) \\ &= (\dot{B}/Y)/(B/Y)-(\pi+g(Y^r)) \\ &= d/b-(\pi+g(Y^r)). \end{aligned}$$

Therefore, with $g(B/Y)=0$ in steady state, it follows $d/b=\pi+g(Y^r)$, q.e.d.

With an inflation rate of 2 per cent (the ECB's target value) real GDP growth must be 3 per cent in order to reach a nominal GDP growth rate of 5 per cent. Only then the debt ratio can be stabilised at a level of 60 per cent with a deficit ratio of 3 per cent. Consequently, a country like Germany with a considerably lower trend rate of growth will observe continuously growing debt ratios. On the contrary, countries with higher trend rates of growth such as Ireland can reach stable debt ratios even with deficit ratios beyond 3 per cent. The striking point is what could be called an "inflation paradox": a high inflation rate contributes to the compliance with the Maastricht debt/deficit criteria, whereas a low inflation rate (typically below the ECB's 2 per cent target) makes adherence to Maastricht's debt and deficit rules difficult. Hence, the Maastricht criteria understood as the convergence criteria allowing for entry into the Euro area suffer from an intrinsic inconsistency of goals: compliance with one criterion (the inflation criterion[22]) makes compliance with other criteria (debt/deficit criteria) difficult.[23]

As we stated above, the 3 per cent limit is to a large extent arbitrary. In fact, there is no explicit economic justification why precisely the 3 per cent threshold

[22] The Maastricht inflation convergence criterion stipulates that the maximum permissible inflation rate must not be higher than 1.5 percentage points above the average of the three best performing EU countries.

[23] Another goal conflict related to the Maastricht criteria may be entailed by the Balassa-Samuelson effect in the new EU Member States from Central and Eastern Europe: most of these new Member States will be faced with the dilemma of either implementing excessively restrictive policies to contain inflation during the qualification period for EMU, or accept that the common currency can only be adopted at a later stage (Gros, 2004, p. 1).

of all possible thresholds must not be exceeded (PEFFEKOVEN, 2004, p. 10). In fact, there is no clear economic rationale for that limit: as EICHENGREEN (2003, p. 68) puts it, "[t]here is no a priori reason to think that dire economic consequences will follow if the 3 per cent limit is violated … This numerical threshold is not well grounded in theory." As we have shown above, it depends on the real growth rate, the inflation rate and other variables whether compliance with the 3 per cent limit implies a sustainable public debt. In fact, the only reason why the 3 per cent threshold is not completely arbitrary is that it can be derived from stabilising the debt ratio at (the then average) 60 per cent of GDP, given a nominal GDP growth rate of 5 per cent (see above). But if, after all, the stabilisation of the debt to GDP ratio at 60 per cent is a central underlying objective of the SGP, then those Member States with higher debt ratios should be forced to consolidate their public finances more strongly, i.e. they should have to keep to deficits even smaller than 3 per cent of GDP. Vice versa, EMU countries with lower debt ratios could be granted wider deficit margins (PEFFEKOVEN, 2004, p. 10).[24]

Such a more flexible, country-by-country approach (which essentially consists of conditioning the deficit ceiling on the debt level and, also, on growth and inflation) would have some major advantages: firstly, low-debt countries would have more room for manoeuvre in economic downturns. Secondly, the incentives for sound budgetary policy are increased if countries are rewarded by "status upgrading" in the form of bigger room for manoeuvre (EEAG, 2003, pp. 62-63). Thirdly, the new Member States (whose catching-up process is very important) would particularly benefit from such an approach, since many of them have low debt ratios, but high deficits.

[24] Clearly, holding the debt ratio (B/Y) stable in its steady state is a very different objective than eventually driving it to zero, as implied by the "close to balance or in surplus rule".

Table 1: *A more flexible country-by-country approach: The deficit limit conditioned on the debt ratio*

Debt ratio (per cent of GDP)	Countries in the debt range	Nominal GDP growth rates (in per cent), with $g(Y)=\pi+g(Y^r)$[25]
<10	Luxembourg, Estonia	6.3 (LU), 9.7 (EE)
<25	Latvia, Lithuania	14.2 (LV), 8.8 (LT)
25-34	Slovenia, Ireland	8.1 (SI), 8.2 (IE)
35-44	United Kingdom, Czech Republic, Denmark, Finland, Slovak Republic	5.7 (UK), 8.6 (CZ), 4.2 (DK), 3.4 (FI), 8.9 (SK)
45-54	Spain, Poland, Sweden	6.4 (ES), 8.6 (PL), 4.8 (SE)
55-64	Netherlands, Hungary, Austria, Portugal	2.3 (NL), 10.1 (HU), 3.0 (AT), 3.2 (PT)
65-74	Germany, France, Malta, Cyprus	2.9 (DE), 4.3 (FR), 4.4 (MT), 6.5 (CY)
75-84	----------	
85-94	----------	
95-104	Belgium	4.5 (BE)
>104	Italy, Greece	4.2 (IT), 7.4 (EL)

Source: Own calculations; debt ratios and growth rates are those expected for 2004 (taken from European Commission, 2004d).

In Table 1, we have grouped the 25 EU Member States according to their debt ratios (in ranges). The third column illustrates the nominal GDP growth rates of those countries. Hence, Table 1 contains information about all the relevant variables that influence the "allowed" deficit ceiling that a country should stick to. We always have to keep in mind the important underlying formula:

$$g(B/Y)=d/b-(\pi+g(Y^r)),$$

which is a steady state relation if $g(B/Y)=0$: then the debt ratio is constant. d/b could take the value 3/60=5 per cent, which implies that with a 5 per cent nominal growth rate and a 3 per cent deficit ratio, the debt ratio can be kept constant at 60 per cent of GDP (steady state).

[25] Calculated as the sum of the percentage change of real GDP (on preceding year) plus the percentage change of the GDP deflator (on preceding year), both from the 2004 estimates (October 2004).

But what if a Member State has either a much higher or a much lower debt ratio than 60 per cent? Obviously only four out of 25 countries, which are furthermore relatively small, find themselves in the debt ratio range between 55 and 64 per cent. And what if a Member State has a nominal growth rate that is very different from the alleged 5 per cent which are at the basis of the 3/60 relation? The catching-up economies of Central and Eastern Europe do have higher growth rates *and* higher inflation (the latter due to the BALASSA-SAMUELSON effect) than most of the old EU members – and nearly all of them have a nominal GDP growth rate larger than 5 per cent (see Table 1, third column). Following from the Proposition above, with higher growth rates *and* higher inflation, they can afford to have higher deficits without jeopardising the long term sustainability of their public finances. Consequently, the "one size fits all" 3 per cent limit is overly restrictive for these countries and should be replaced by a more flexible limit (BUTI, EIJFFINGER, and FRANCO, 2003, p. 20). We now take a closer look at three selected countries in order to illustrate that the SGP's "one size fits all" design and its 3 per cent limit are inappropriate.

Latvia: A Very Low Debt Ratio and Very High Nominal GDP Growth

Latvia e.g. belongs to the group of low-debt countries, with a debt to GDP ratio of only 14.6 per cent in 2004. Furthermore, its nominal GDP growth rate exceeds 5 per cent by far: in 2004, real GDP growth and inflation add up to 14.2 per cent (see Table 1). Now with the steady state relation $g(B/Y)=0$, in order to keep this very low debt ratio constant, Latvia could only afford a 2.1 per cent deficit ratio (given a 14.2 per cent rate of nominal growth).[26] But given that the relevant debt ratio in the SGP framework is not 5 per cent, but 60 per cent, even with a deficit ratio of 5 per cent p.a., Latvia's debt ratio (then growing at a 20 per cent rate) would still stay below 60 per cent of GDP for many years, if not decades. This is particularly true because of the fact that with increasing debt to GDP ratios, the country's high nominal growth rate tends to contain the debt to GDP ratio's increase more and more. So clearly, the 3 per cent limit imposed by the Maastricht criteria is overly restrictive for a country like Latvia.

[26] This is due to the fact that, as EEAG (2003, p. 62) puts it, "nominal GDP growth automatically tends to reduce the debt to GDP ratio less the lower this ratio, requiring lower deficits if the ratio is not to increase."

Austria: An Average Debt Ratio, But Sluggish Nominal GDP Growth

Austria belongs to the group of countries with debt ratios relatively close to the Maastricht value of 60 per cent of GDP: in 2004, Austria's gross general government debt amounts to approximately 64 per cent of GDP. But the country' nominal GDP growth rate is clearly lower than 5 per cent: in 2004, real GDP growth and inflation add up to only 3.0 per cent (see Table 1). Now with the steady state relation $g(B/Y)=0$, in order to keep its debt ratio constant, Austria could only afford a 1.92 per cent deficit ratio (given a low 3.0 per cent rate of nominal growth). Theoretically speaking, Austria would have to limit its deficit to even less than 1.91 per cent of GDP, since stabilising the current debt ratio is not enough: it has to be reduced to be brought back to under the 60 per cent threshold. As opposed to the Latvian situation, in the case of Austria, the 3 per cent limit imposed by the Maastricht criteria is not restrictive enough.

Italy: A Very High Debt Ratio, With Moderate Nominal GDP Growth

Italy has a very high debt ratio, even beyond 100 per cent of GDP: in 2004, it amounts to 106 per cent. The country's nominal growth rate is moderate, with 4.2 per cent in 2004 (see Table 1). With nominal growth falling short of the 5 per cent threshold, and an excessively high debt ratio, Italy would have to stick to much stricter deficit rules: with a Maastricht-compliant deficit of 3 per cent of GDP (and 4.2 per cent of nominal growth), Italy's unduly high debt ratio would hardly be reduced (there would only be a 1.37 per cent decrease p.a.). At that speed, it would take Italy several decades to cut its debt ratio to below 60 per cent of GDP. Hence, Italy should be forced to consolidate more strongly its public finances, if the underlying rationale of the Maastricht criteria is to make EMU-wide public debt level off at 60 per cent of GDP.

7 Conclusion

In this paper, we have analysed what effects public debt and public deficits have and whether, after all, public debt should be limited. Then the case for budgetary policy coordination in the special context of the Economic and Monetary Union was outlined. In this context we have shown that there seems to be a raison *d'être* for some sort of budgetary policy coordination. But if there is, does it have to look like the SGP? Which rules are efficient and stable? After a short

presentation of the SGP framework, we have critically reviewed the SGP's main shortcomings as well as some important reform proposals currently discussed in the literature. Finally, we presented the case for a more flexible country-by-country approach. This argumentation is central to this paper, since one of the most obvious shortcomings of the current SGP framework is the "one size fits all design" of the budgetary rules and the quite arbitrary 3 per cent limit. As the SGP disregards that countries are different, it limits necessary flexibility to conduct country-, inflation- and growth-specific fiscal policies. While this was problematic already in the EU-15, it is even more so in the EU-25, given that the new Member States' economic variables such as real GDP growth, inflation and public debt differ significantly from those of the old members, due to their transition process and catching-up endeavours.

However, not only the new Member States deserve a country-specific treatment. Also Germany would do so – on even two accounts: firstly, the heavy financial burden induced by German reunification should be taken into account somehow. Since reunification, 1200 billion Euros have been transferred to Eastern Germany. Even today, roughly 85 billion Euros still flow to the East annually, more than 4 per cent of Western German GDP. This clearly is a very special situation that no other EMU member is confronted with. Moreover, these financial flows to Eastern Germany also occur in the interest of European integration and the EU's objective of interregional cohesion. Obviously, Germany would not have a problem to comply with the 3 per cent limit were these transfers (at least partly) subtracted from the general government balance. Secondly, Germany's high net payments to the EU budget (roughly 0.25 per cent of German GDP in 2002) clearly increase its public deficit, whereas the net recipients such as Spain (whose net receipts amounted to approximately 1.3 per cent of its GDP in 2002) benefit from inflowing funds when consolidating their general government balance. Hence, it is worth to consider taking net payments and net receipts into account when performing the deficit calculation. This would be a further step towards a more flexible, country-by-country interpretation of the SGP.

Clearly, we do not ask for excluding a plethora of (mostly country-specific) items from the calculation of the deficit figures. This would lead to a situation in which every Member State would try to push through its own special wishes, and the SGP would eventually be blurred completely. Yet, in Chapter 6 of this paper, we have outlined a clear case for a more flexible country-by-country interpretation of the SGP, depending on public debt (which in any case is more important for long-run fiscal sustainability and price stability than the annual

deficit), real GDP growth and inflation in the individual Member States. In this respect, the European Commission's most recent reform proposals (to put more focus on public debt and sustainability, to take better into account country-specific economic circumstances and developments etc.), which have been reviewed in Chapter 5.1 point into the right direction – but clearly not far enough. The identified "inflation paradox" calls for the greater consideration of inflation differences across Member States. Furthermore, German Chancellor Schröder's recent request to take into account Germany's and other countries' net payments to the EU budget deserves a careful consideration, since it would be odd if the EU's main budget contributors were indirectly punished for their net payments.

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