Should Budgetary Policies Be Coordinated Further in Economic and Monetary Union – and Is That Feasible? *

Niels Thygesen

1. Introduction

The provisions of the Maastricht Treaty relating to Economic and Monetary Union (EMU) contain a remarkable asymmetry between the treatment of monetary and exchange-rate policy on the one hand and other macroeconomic policies, in particular budgetary policies, on the other hand. Monetary policy is to be executed in a centralized way through a European Central Bank (ECB), but national governments will retain a substantial amount of national autonomy in budgetary policy. This autonomy is constrained, however, by reference values for public deficits and public debt as shares of GDP, observance of which will be monitored by the Council of Finance Ministers (Ecofin) with the possibility of imposing (relatively mild) sanctions on countries with a deviant behaviour. These provisions are designed to prevent strongly divergent behaviour by individual participants which might destabilize the whole union. But for countries which have attained or are close to the reference values there will be no interference in their design of budgetary policies. Such policies will continue to be subject to national decision-making only in accordance with the so-called subsidiarity principle.

□ University of Copenhagen (Denmark).

* This article is a slightly revised version of the author's contribution to *SNS Konjunkturrådet Report for 1996* (in Swedish). The report will appear in English under the title *What Does Sweden Want from the European Union?* SNS, Stockholm. The author is grateful for critical comments from colleagues at SNS and in the CEPS Economic Policy Group where some of the subjects touched upon are dealt with more thorougly, see Gros *et al.* 1996. The usual disclaimer applies.

The Treaty does emphasize (Article 103) a general intention that member states "regard the economic policies as a matter of common interest and coordinate such policies in the Council". But even though the Treaty does expand substantially the procedures for multilateral surveillance, cooperation will be clearly voluntary – with the exception of the obligation to attempt to stay below the reference values – in contrast to the centralized management of money and exchange rates *vis-à-vis* the rest of the world.

Most economists have shown sympathy for this asymmetry and some, particularly Buiter, Corsetti and Roubini (1993), have even found that the Treaty went too far by constraining divergent behaviour through the reference values for public deficits and debt as shares of GDP. According to their view a monetary union should in itself be sufficient to assure an adequate degree of coordination of other policies as well. The mechanism for achieving that is that the exclusion of the possibility of devaluation makes large budgetary imbalances in the public sector more risky, particularly since the Maastricht Treaty also forbids monetary financing and mutual support actions between the participants in EMU (a so-called "bail-out"). The long-term budgetary constraint should become more visible to all governments under these circumstances.

The public debate and, in particular, many contributions from policy-makers express a considerable degree of uncertainty *vis-à-vis* the optimistic and liberal attitude in the Treaty. Doubts are voiced as to the feasibility of a construction where the ECB will find itself alone in the arena of economic policy in the European Union without a serious counterpart in the political area – obviously in the form of the Ecofin Council – with direct legitimacy from the voters. The construction could at the same time make it difficult to arrive at a suitable policy mix in the EU after the start of the EMU. Fundamentally these critics doubt whether the participating countries will show a sufficient degree of cooperation in their design of national budgetary policies to assure the survival of EU. The ability and the willingness of the Union to check divergence in individual member states after the start of the third stage is subject to serious question, not least when one looks at the fairly mild sanctions in the Treaty.

This topic has recently become even more urgent in the public debate. Members of the Bundesbank Council, the President of the French national assembly, and a number of British politicians have over the past year criticised the Treaty for implementing a monetary

union before political integration has advanced sufficiently, in particular with more emphasis on mandatory coordination of other economic policies.

The following sections of this article will discuss several subjects of relevance to an evaluation of the adequacy of the Maastricht Treaty: initially two earlier and more ambitious attempts to construct an EMU in Europe – the Werner plan of 1970 and the Jenkins plan of 1977 – and the underlying motivations for the current, much looser and more decentralised, version of EMU are reviewed. The next section asks why the reference values for public deficits and debt as shares of GDP have been formulated as they are in the Treaty and whether they might be made more precise so as to render them less arbitrary and more operational. This is obviously an opportunity for reviewing the proposals made by the German Finance Minister, Mr Theo Waigel, in the Ecofin Council, to establish a so-called "Stability Pact", backed-up by more automatic sanctions than those foreseen in the Treaty.

Finally two questions are reviewed of some relevance for the evaluation of the adequacy of the budgetary policy vision of the Treaty: is a still largely national budgetary policy sufficient to absorb the effects of country specific disturbances, or might a fiscal transfer mechanism as is known from large federal states, be a valuable additional element in stabilisation policy? The second question relates to the demand for an extension and deepening of political integration, which the implementation of the EMU is seen to require: which elements of political union are particularly important in this context, and is there a choice between a largely rule-based framework of cooperation and a centralization of budgetary authority at the European level? A short concluding section ends the article.

Earlier models for EMU

The attitude among European policy makers to the degree of budgetary policy coordination required to implement and sustain a monetary union has changed in a remarkable way over the past 25 years. The first complete outline of an EMU – the so-called Werner plan, elaborated in 1970 by representatives of the six original member

states – contained proposals not only for a common central bank of a federal nature, but also for a new centre of decision-making for other economic policies. This latter centre, consisting of a greatly reinforced Ecofin Council – would be entrusted with authority to impose on individual member states changes in their respective budgetary policies. Recommendations might relate not only to the general stance of budgetary policies, but might also request changes in individual instruments of revenue or expenditure, notably in the rate of value-added tax. Subsequent discussion showed clearly, however, that a number of member states, not least France, had not accepted these far-ranging implications.

The Werner plan aimed at reaching EMU in 1980 after three stages, in close analogy to the present process. The transfer of budgetary authority would only take place at the end of this process. The recommendations of the Werner report and the decisions to which they led in Ecofin in 1971-74 reflect clearly the strong confidence at the time in the reliability of budgetary instruments in stabilisation policy. This confidence dates back to major parts of the academic literature of the late 1960, as exemplified in OECD (1968). The Werner report did not address itself to the subjects of better convergence and low inflation, possibly because the starting point in this respect was already quite promising. But the report saw a long-term risk of divergence in economic policy and performance, and it justified radical proposals for mandatory budgetary policy coordination with reference to these risks.

The differences relative to the Maastricht Treaty illustrate clearly how far the prevailing view of stabilisation policy and the international linkages between policy changes made in different countries have changed. Prices were regarded as sticky and as primarily determined by wage negotiations and wage drift; for that reason the Werner report also recommended coordinated initiatives of income policy. Disequilibria on current accounts which had been at the centre of attention in the attempts of the 1960 to evaluate the need for international coordination were seen as closely linked to differences in demand growth due to differentiated use of instruments of stabilisation policy between the domestic economy and its partners. There was therefore a particular interest in assuring through central decision-making procedures that these external disequilibria did not develop too far. Capital movements were still to a large extent regulated, but the report proposed to liberate them fully in the final

stage of EMU – a Very radical step given the starting point. There are no proposals in the Werner report, however, for enlarging the Union's own budget or for fiscal transfers directly among member states.

For a number of reasons EMU did not materialise on this occasion; the first oil crisis, the dissolution of the Bretton Woods system and divergent reactions to these large, but broadly similar disturbances in the member states put an abrupt end to the project in 1974-75. But already in 1977 a new outline was proposed for a monetary union which emphasised the budgetary prerequisites. This proposal had in mind as its central feature a radically enlarged federal budget so that the European institutions themselves could take upon it tasks of stabilization for all countries and for individual participants through a system of fiscal federalism. The analytical underpinnings were provided in an expert report for the European Commission, McDougall (1977), and were linked to revived proposals for monetary union in an imaginative way by the then President of the European Commission, Roy Jenkins (1977). In an early use of the principle of subsidiarity, Jenkins argued elaborately for targeting stabilization, allocation and distribution objectives through an enlarged federal budget. Since the enumeration of federal tasks of an allocational nature was rather long, the estimated size of the necessary federal budget for the then nine member states was so large that it deterred any subsequent debate at the political level.

Nothing was left of these ideas when the European Monetary System (EMS) was proposed and launched one year later. At the time there was simply too much budgetary divergence between member states to permit a realistic discussion of the proposals in the McDougall report relating to fiscal federalism, even if confined to the stabilization objective – and there was no willingness to resume the proposals of the Werner report to centralise authority over national budget-making. Would any government have been willing to accept a system of sizeable transfers between states directly or via a federal budget in the absence of more elaborate fiscal budgetary policy coordination and mandatory surveillance? Instead the member states settled for an EMS which was in the beginning a much looser monetary cooperation framework which did not appear to impose wide-ranging demands for budgetary coordination.

Over its first decade the EMS efforts did indeed lie almost entirely in the monetary area. After the second oil price shock

member states reacted once more in a different way in their budgetary responses, though to a less divergent degree that in the 1970s. Coordination appeared about as difficult as in the Group of Seven (G7) where, despite repeated efforts by the IMF to include indicators of budgetary policy, there was never any repetition of the *ad hoc* coordination effort of the Bonn summit of 1978, much less any systematic efforts of coordination. But by 1988-89 EMU was again on the agenda, initially because of the decision to free capital movements entirely which led to the appointment of the so-called Delors committee to evaluate possible stages in the implementation of EMU. In this context budgetary policy coordination was again inevitably put on the agenda but in a new and more decentralized variant with only a limited emphasis on coordination of a traditional nature.

The current EMU model: the Delors Report and the Maastricht Treaty

The Delors report (1989) did not propose either centralization of budgetary authority or a larger federal budget to develop fiscal transfer mechanisms. The report approached matters in a way which is also closely reflected in the Maastricht Treaty: continuing coordination of national budgetary policies is superfluous in a well-functioning monetary union, as long as the latter is underpinned by mechanisms which restrain strongly divergent budgetary policies in individual member states. These constraints lie in the Treaty's provisions that no other member states can be held responsible for another member state's obligations – the so-called "no-bail-out" clause in Article 104b – and that tight surveillance will be applied by Ecofin in the monitoring of "excessive budget deficits" as outlined in Article 104c. A further reinforcement is produced by the fact that the ECB and the national central banks (already from the start of the second stage) are prohibited from participating directly in the financing of public sector deficits.

The philosophy of the Maastricht Treaty is clear: the union should leave the design of budgetary policies to the individual member states as long as the latter respect certain limits to deficits

and guidelines for debt reduction – or at least react to the recommendations addressed to it by Ecofin. The most forceful long-run disciplining factor in EMU is the absence of the possibility to devalue; the long-term budgetary restriction will be more visible in these conditions.

But this was not seen as fully adequate when the Treaty was drafted to rely solely on these principles. The risk of rising interest rates as a result of growing budget deficits is reduced and the risk of foreign exchange crisis is totally eliminated for participants in EMU whereby well-functioning signalling mechanisms from the past disappear. Financial markets must be expected, however, to react through higher interest rates *vis-à-vis* a country with a growing deficit and debt. Even if the foreign exchange risk disappears, the credit risk will remain in EMU to the extent that the "no-bail-out" clause is credible. But the disciplining effect of financial markets may turn out to be delayed in the initial phases and excessively brutal later, if well-founded doubts as to a country's ability to remain in EMU should arise. This way of looking at financial markets is typically inspired by the initially very liberal, and then suddenly excessively cautious, attitude to lending to Latin American and other large indebted nations in the beginning of the 1980s. It is well expressed in Lamfalussy (1989) which was an important contribution to the design of the role given in the Maastricht Treaty to norms for deficits and debt and to the peer pressure to which a country's Finance Minister will be subjected in Ecofin in order to live up to the reference values after entry into EMU. The Treaty aims at giving to Ecofin most of the role that financial markets play in disciplining individual country budgetary policies under floating exchange rates or fixed, but adjustable rates.

In the transition phase prior to the start of the third stage the Treaty assumed that the risk of not being in the monetary union as a result of failure to meet the budgetary convergence criteria would operate as a sufficient deterrent to make other sanctions superfluous. This may still be a correct assessment; even to those countries which in principle are expected not to participate in EMU (United Kingdom and Denmark) meeting of the criteria of convergence has remained a central objective, even though in these countries cautious budgetary policies must be defended on grounds other than as a sacrifice necessary for entry into EMU.

When a country decides to enter the third stage of EMU and locks its exchange rate irrevocably and proceeds to introduce the single currency, this structure of incentives weakens significantly. It should in principle remain for those countries that have not joined EMU because they did not yet meet the economic requirements. It will even remain in weak form for those who have opted out, because they still may wish to reconsider their decision later. But for the participants the incentive to virtue does weaken. In addition, there are no exclusion provisions for countries which subsequently diverge – only some relatively mild and long drawn-out sanction procedures.

The convergence criteria cannot readily be regarded as coordination of national budgetary policies in the traditional and wider sense that a group of countries coordinate their budgetary policies in order to achieve more satisfactory macroeconomic performance for all participants, possibly after compensation to those countries which in a first round have to undergo costs as a result of the agreed changes. This traditional type of coordination does not play a major role in the Treaty. Budgetary coordination in EMU can hardly be expected to deepen relative to the voluntary and intermittent coordination which has been observable in the past system of cooperation or for that matter at the global level in the G7. Signs that traditional features of coordination had been retained in the EMU project would have been the inclusion of indicators of the economic performance of the participants – domestic indicators such as the output gap or the average rate of unemployment, possibly relative to the estimated level of the natural rate of unemployment (NAIRU), or external indicators such as the EMU countries' current account position and/or changes in the exchange rate of the single currency *vis-à-vis* other main international currencies – had been given a modifying role in aggregate budgetary policy for the union. If the EMU participants after the start of the union were to find themselves in a situation similar to that of the recent past with continuing underutilization of productive capacity, surplus on the combined current account and indications of an overvalued currency, these would provide arguments for not interpreting the convergence criteria as restrictively as in other circumstances. Such a situation might also lead to recommendations from Ecofin to countries with the lowest budget deficits and debts urging them to conduct a less restrictive budgetary policy.

It is possible and maybe even inevitable that such recommendations and assessments will nevertheless win support in Ecofin

and in the European Council without changes in the Treaty. But these recommendations would in that case be without the firm backing which recommendations relating to individual countries' compliance with the convergence criteria has been given in the Treaty through a formal status and sanctions which non-compliance would lead to. To follow the recommendations in EMU would remain voluntary.

At the same time it is obvious why there was reluctance to coordinate budgetary policy in this sense when the Maastricht Treaty was negotiated. There was an explicit expectation that the decentralised design of budgetary policy would imply that all realistic – and possibly some unrealistic – possibilities of arriving at full resource utilisation would in fact be used. When the Treaty was negotiated in 1991, the latest figures for the average public sector deficits in the high activity year of 1990 showed a deficit of a bit more than 3% of GDP for the 12 member states combined. That the deficits were so large late in an economic upswing did not suggest that they could be kept at this level at a more normal or subnormal level of capacity utilisation; actual GDP in 1990 is assumed to have been 2% above trendwise or potential GDP. It is not surprising that governments underestimated the seriousness of the imminent economic downturn.

Several countries had in the beginning of the 1990s used every scope for manoeuvre in budgetary policy in order to stimulate activity and some had gone beyond that. It appeared logical to use the negotiations of the Maastricht Treaty to create incentives to rebuild some budgetary room for manoeuvre through consolidation, at least to the point of restoring a position where automatic stabilisers could again be allowed to work under an economic downturn. To open up the possibility of mandatory decisions on budgetary policy coordination of a symmetric nature had in this context to appear undesirable. This was the approach not only of cautious countries such as the Netherlands or Germany – and the Germans were well aware in 1991 that they would quickly be faced with a further deterioration of public finances – but it was shared by countries which had already used up their future room for manoeuvre such as Italy and Belgium. The latter countries greeted an external pressure for consolidation of their budgets over a lengthy period as a constructive contribution to their own inner political process.

There were accordingly both more permanent and temporary reasons for the very striking difference in the evaluation of the need for budgetary policy coordination in 1970 and two decades later. The optimism relating to the scope for budgetary policy as a reliable tool kit for demand management policy had been replaced by the almost cynical view that a number of countries had such obvious difficulties in managing their own public finances that they clearly lacked the capacity to undertake international obligations in this area. In other words: the largely Keynesian view of the demand-regulating effects of budgetary policies had given place to a perspective on public finances which stressed the conclusions of the public choice school and the political business cycle theorists in their negative view of the national political systems' short-term interest and hence bias in the direction of large public deficits.

These evaluations will only be modified slowly, even under the pressure of the unexpected economic downturn the EU countries experienced after the signing of the Treaty. The European Commission and the European Monetary Institute have recently estimated that the automatic effects of lower capacity utilisation in 1995 than in 1990 is in the order of 2% of GDP. Member states have on average succeeded in eliminating just under half of that deterioration through discretionary reductions in expenditures and increases in tax rates. The combined measured deficit in the member states was actually nearly 1½ percentage points larger in 1995 than in 1990. That is not a promising starting point for weakening the efforts to reduce budget deficits quite apart from the need for several countries to do so at the same time in order to meet the convergence criteria in 1997.

In a longer perspective there should be better opportunities for developing a more differentiated view of budgetary policies, if indeed the present transitional phase ends successfully and EMU starts on schedule in 1999 with a participation that is not too narrow. The most recent discussion of the convergence criteria will give an impression of where this possible room for manoeuvre lies through interpretations of the Treaty and supplementary agreements without Treaty changes. We turn to this subject in the next section.

The convergence criteria: interpretations and elaborations

The Maastricht Treaty contains two criteria which elaborate the notion of excessive budget deficits: the deficit should not exceed 3% of GDP unless (1) the share has fallen significantly and continuously or (2) the transgression is only exceptional and temporary; but in both cases the deficit ratio should be "close to" the reference value of 3%. The public debt ratio should only exceed 60% of GDP if that percentage share is falling significantly and approaches the reference value "at a satisfactory pace". The language in Article 104c shows clearly the difference in the degree of precision with which the two criteria may be expected to be applied both at the start of EMU and later. The deficit can only marginally exceed 3% while the debt criterion – in the absence of further elaboration of what may be regarded as a satisfactory pace of adjustment – must be regarded as so vague that it is hardly applicable.

A number of economists, including Buiter, Corsetti and Roubini (1993), have rightly drawn attention to the arbitrariness in the level of the two reference values. They were apparently chosen because they represented approximate average behaviour in member states around 1990. A more refined justification could be that the public sector in most European states has physical assets which typically amount to at least 50-60% of GDP. According to the lessons of classical public finance it is not unreasonable to finance the accumulation of physical assets which improve the functioning of the economy by issuing debt instruments. There is, incidentally, in the Maastricht Treaty some reliance on this line of thought as it applies to budget deficit. In evaluating whether a deficit is excessive one should also pay regard to the level of public investment, the so-called "golden rule".

Both historical experiences and theoretical analysis suggest that higher values than the two arbitrary percentages would have been sustainable and that, in particular, an explicit demand that the debt ratio should be reduced over a short span of years to the reference value might lead to an unacceptably deflationary budgetary policy for the EU in the aggregate (see Hughes Hallett and Ma 1995). The level of the debt can be reduced significantly over a short span of time, but hardly without reducing at the same time the denominator in

the debt ratio, GDP. The only positive statement most academic economists have found it possible to make is to say that the two convergence criteria are internally consistent under reasonable assumptions, i.e. if the GDP grows on average by 5% a year, for example equally composed of real growth and inflation, while the nominal interest rate is also 5%. In these circumstances a permanent budget deficit of 3% implies that debt ratio converges to 60% regardless of the starting point. One reasonable question is therefore whether it would not have been enough to focus only on the deficit criterion which should enable a country to control debt creation rather than to burden the start of the EMU and its early existence with a criterion which is, either in a tough interpretation, unrealistic – and that is unfortunately the view the public debate has absorbed most readily – or fades away as so vague that it becomes *de facto* inoperational.

There are however strong arguments for retaining both criteria while differentiating them more in accordance with the starting position of the individual member state. The first argument in favour of retaining both criteria is that the linkage between deficits and debt changes from year to year is not of the simple 1:1 character which one would readily assume. Quite apart from continuing changes in the valuation of public assets in liabilities which influence debt but not the annual surpluses or deficits, occasional large debt volumes are absorbed into the public sector, debt from para-state organisations in the country. A dramatic recent example is found in Germany where the Federal Government in 1994 took over the debt of Treuhandanstalt from the privatization programme which lead to a rise in the debt ratio of more than 8%, while the measured deficit was no larger than was compatible with a constant debt ratio. In November 1995 the French government announced a commitment to take over the debt of the French Railroads corresponding to nearly 2.5% of GDP. Such transactions are in reality an expression of undervaluation of the ongoing public deficit throughout several periods. It is therefore useful to have also as a criterion changes in the debt ratio besides the deficit.

The second argument is that a specification of what could be regarded as a satisfactory pace in the reduction of debt would make it possible to arrive at more differentiated demands for reducing also the size of deficits than a mechanical reference to the norm of 3%. It would be natural to expect that the countries that lie the furthest

from the reference value for the debt ratio – Belgium is currently at 134% and Italy at 125% – would also have to make the greatest effort to reduce the debt ratio, implying that these countries have to drop below 3% in deficit in order to show satisfactory behaviour. This could be achieved by setting a maximum period within which the debt ratio, through a linear reduction year after year, would be brought back to the reference value. If one sets this period to e.g. 20 years starting from 1995 Belgium and Italy would have to reduce their debt ratio by 3-4 percentage points every year in order to stay on course. However, countries with a debt ratio of less than 80% of GDP would be able to manage with a reduction of under one percentage point a year. A more elaborate discussion and presentation of illustrative results may be found in the report of a working group from the Centre for European Policy Studies (see Gros *et al.* 1996).

The way the debt criterion is expressed in the Maastricht Treaty makes it in reality extremely difficult to apply. There are good prospects that the criterion will in fact be interpreted in a very flexible way. But in order to avoid any impression of discriminatory behaviour in the form of accepting some countries in EMU with a much higher level of the debt ratio than other countries excluded from the EMU as a result of failure to comply with the convergence criteria – think of Belgium *vis-à-vis* Spain or even Italy – it would be valuable if Ecofin could adopt a specification of the reduction required of the debt ratio. Such an elaboration would open the possibility of using the debt criterion in a more constructive way. If an agreement could be reached on this point Ecofin (after proposal by the European Commission and after hearing the European Parliament and the EMI or the ECB) already has authority to make such a decision which relates to the details in connection with the convergence programme (see Article 6 in the special protocol on the convergence criteria).

As far as the criterion of the public sector deficit relative to the GDP is concerned interest has focused in the more recent period both on the degree of toughness with which the criterion may be expected to be applied at the entry to EMU and on how it should be interpreted after the Union has started, including the question of what sanctions may be applied to keep countries at a deficit not larger than 3%.

It must be expected that a restrictive interpretation of the criterion will be applied as the first group of members try to enter the

EMU. This conclusion arises from the debate in Germany, inspired by the decision of the German Constitutional Court of 12 October 1993 and the broad acceptance by other countries of such an interpretation. In addition, one may observe as was already done in the previous section that making the first effort to select participants in EMU in 1998 (on the basis of economic results from 1997) the potential participants will have moved 1-1½ years ahead in the current moderate upswing, which has been visible in the European Union since the bottom of the recession which for most countries can be identified as the 1992/93 period. More of the initially large output gap left by the recession will thus have been eliminated; the latest estimate by the European Commission suggests that this gap may already be nearly eliminated by the end of 1996 (see European Commission 1995). Since the fall of 1995 estimates of growth in 1996/97 have been scaled down somewhat, but not to an extent that this conclusion is in serious doubt. Most member states continue to expect a significant reduction of the deficits between 1995 and 1997.

Keeping this in mind it will not be unreasonable to adopt a somewhat more stringent interpretation of the data for 1997 than if data for 1995 or early estimates for 1996 were to have been used as was originally intended in the Maastricht Treaty. The first effort was to be made at the end of 1996 to see if a majority of countries were ready to join the first stage. The postponement of this deadline last summer cannot however remove the flexibility which the Treaty has put into the words "close to" the reference value. There is an analytical base beyond German stubbornness which can justify that candidates for EMU should in 1997 strive to move somewhat closer to the reference value of 3% than it would have been reasonable to expect in 1995/96. If a country without special justification cannot arrive at the deficit of 3% in 1997 there is a strong presumption that that country would be required to conduct a procyclical national budgetary policy after entering into EMU in order to keep the deficit under 3% even in a year of a lower degree of resource utilization than in 1997. This discussion points to the unsatisfactory nature of a mechanical application of the measured budget deficit as a convergence criterion both before and after a country's entry into EMU. Governments and central banks wanted in the Maastricht negotiations to settle for figures which had a high degree of objectivity and which could be given a ready interpretation as an expression of the

burden on financial markets as public deficits which had to be financed. In this context there were strong arguments for using actually measured deficits, even though a comparison with the debt changes as argued above suggests that the figures are not as objective as one would like. If one had not seen the size of the debt as an important problem one could have focused instead on the so-called primary deficit, that is the measured deficit corrected for public sector net interest payments.

A more analytically satisfactory alternative would however have been to focus on the so-called structural deficit, i.e. the measured deficit (or possibly the primary deficit) adjusted for the automatic budget effects of departures between actual and potential (or trendwise) output. If budgetary figures adjusted in this way were a reliable expression of underlying trends in public finances and thereby of the sustainability of a deficit of a given size, the criterion would automatically be free of effects which could be attributed to the different participants being in different stages of the business cycle. But unfortunately calculations of structural budget deficits, however useful they may be, are uncertain and controversial. If one cannot recommend using the structural budget deficits as a convergence criterion it is realistic to allow estimates of this deficit to influence both the toughness of the interpretation of the admission criterion at the time of the 1998 decision and the 20 average level around which the deficit should fluctuate after EMU has been set up.

It is in reality this debate which the German Finance Minister Theo Waigel has taken up in the fall of 1995 and discussed so far in a preliminary way with his colleagues. The European Council in Madrid asked Ecofin to continue working on the problem in 1996. It is quite likely that Mr Waigel's immediate inspiration was the frustration expressed in the public German debate by many politicians to see the date approaching for the fusion of the Deutsche Mark with other and supposedly weaker European currencies, particularly when these currencies are issued by countries where the budgetary will or ability to observe the convergence criterion on public deficits is less visible than in Germany; the desire to elaborate the Maastricht Treaty in an analytical direction was probably less important. But as other countries now have to reflect on their attitude to the German proposals, it is important to be aware that these proposals actually have an analytical foundation which cannot just be dismissed as

unreasonable, nor be seen as lying outside the framework of the Treaty. The Waigel proposal starts from the above-mentioned observation, viz. that the choice of 1997-data as the basis for an evaluation of possible qualifiers for EMU yields a starting point which makes it natural to apply a tougher interpretation of the deficit criterion than if an assessment had to be made on the basis of a year with a clearly subnormal level of activity. The German view is that it is extremely important to underline continuity in the effort to maintain some public finances and to seek at the time of the start of EMU to arrive at a lower average level of the deficit than what may have been obtained in 1997. Mr Waigel has said that while 3% could be an acceptable level for the deficit in a year of recession it should be the aim of participants in good years to have a much lower deficit so that the average over the business cycle would be a good deal less than 3%, maybe around 1%, or approximate budget balance.

It is obvious that no member state in the European Union will be willing to readily subscribe to this apparent tightening of the convergence criteria without having made a careful analysis of the sensitivity of its public expenses and revenues to the swings in GDP over the typical business cycle. So far the Netherlands, France, Denmark and Finland have expressed themselves in relatively positive terms about the Waigel proposals and no country has so far dissociated itself firmly from the idea.

An especially appealing perspective for the non-German participants in the debate would arise, if one could link a tightening of the interpretation of the reference value for the deficit after the formation of the EMU together with both a specification of the link to the debt dynamics as reported above and with a reasonably flexible use of the budget criterion as applied to 1997 data with the different business cycle situations of different countries in focus. Unfortunately such a trade-off is hardly realistic unless the "stability pact" can be entered into by all member states in the European Union before the time for decision as to who will join EMU in the beginning of 1998. It is possible that some countries will deny that even in this case a decision could be made according to the unanimity rule in Article 6 of the protocol on convergence criteria as suggested above in relation to the interpretation of the debt criterion. The latter would in any case be well justified and might in itself meet a major part of the German concerns about fiscal laxity. The opposition to the further specification of the deficit rule would then come not from the Germans but from some countries who find the proposed "stability pact" too far-reaching.

For countries such as the three Nordic members of the European Union (Denmark, Finland and Sweden) which have an objective to let their public finances target on zero as an average over the business cycle the proposed "stability pact" should not appear unreasonable even though Sweden will have very considerable difficulties in reaching the reference value of 3% already in 1997. It might be worthwhile therefore for the Nordic member states to show a positive attitude to the German proposals when they come up on the agenda in Ecofin in 1996.

A more sceptical attitude seems appropriate *vis-à-vis* another German proposal. Accepting that the possibilities of sanctions in the Treaty *vis-à-vis* EMU participants who after entering the Union transgress the 3% reference value for public deficits and do not accept recommendations adopted in Ecofin to reduce deficits – deposits on non-interest bearing accounts in the ECB and ultimately fines – are probably so weak and so slow to put into operation that they will have little effect, Finance Minister Waigel has proposed that these sanctions should be triggered automatically. A country which transgresses the 3% limit should according to the German proposal without further negotiations deposit an amount corresponding to 0.25% of GDP in the ECB per percentage point transgression. Non-interest bearing deposits would, if the transgression continues throughout a two-year period, be converted to a fine of the same size as the deposit. If we assume for illustrative purposes that the country's deficit shoots up to 5% of GDP and stays there for more than two years the sanction would in the first instance solely amount to the loss of interest on the amount deposited; with an interest rate of 6% on the single currency, the sanction would amount to 0.03% of GDP but this amount would then be converted to a fine amount to 0.50% of GDP. The proposed arrangement would hence contain a major incentive not to disregard recommendations from Ecofin.

The motives behind the German proposals are clear. It must be foreseen that Ecofin would find it very difficult within a reasonable time limit to adopt sanctions against the member states. All experience with European cooperation shows that such a decision will be painful and long drawn out and that it would be difficult to reach an agreement on the size of the deposits and later the fines which on the one hand would contain a sufficiently deterrent effect without on the

other hand deteriorating the budgetary position of a country already faced with difficulties in managing its public finances. Some degree of automaticity in triggering the sanctions cannot *a priori* be regarded as unreasonable, but the proposal may go too far in not leaving Ecofin any possibility of dispensing from the rules under any circumstances. At a minimum one might imagine that Ecofin through a qualified majority vote could dispense from triggering the sanctions, possibly by extending the period when only a deposit on non-interest bearing account in the ECB is required. Under all circumstances it must be acknowledged that launching sanctions is such a far-reaching step and such a clear symptom that EMU is not functioning, that it would be preferable to avoid bringing the participants in a situation where the sanctions are applied.

The position is somewhat different with respect to the two other suggestions for making the convergence criteria more precise through a sharper interpretation of what constitutes a satisfactory pace of debt reduction and by extending the objectives for the deficit to be of a more average, but at the same time a more ambitious nature and hereby bring the criterion closer to an analytical basis where the structural elements in the deficit are taken into account. This latter result would in any case be in better correspondence with norms of budgetary policy discussed in the classical literature on public finance which places considerable emphasis on approximate budget balance over the business cycle as a desirable norm.

Is there a need for a fiscal transfer mechanism between the EMU participants?

Reference was made in the introductory section to an earlier proposal for EMU – the McDougall report and the Jenkins plan for the monetary union, both from 1977 – which saw the evolution of a fiscal transfer mechanism between member states, possibly via the union budget, as a precondition for starting monetary union. Corresponding ideas have not been taken up at the official level in the EMU discussions since 1988. The optimistic assessments which lie implicitly in the Maastricht Treaty is that national budgetary policy should be sufficient to absorb the effects of country-specific disturbances in EMU. National budgetary policy will according to this view – within the limits for the public finances set by the convergence criteria – be sufficient, given the likely modest magnitude of temporary disturbances specific to each member state.

This is an optimistic, but not a totally unfounded view. After exchange rates have been irrevocably locked and the single currency introduced only two adjustment mechanisms remain in EMU beyond the instruments of national budgetary policies which are subject to the convergence criteria. These two mechanisms may both appear weak and unreliable and even undesirable in a European context: migration of labour from regions or countries which experience a specific weakening of demand for their products, and wage and price flexibility which lowers the relative price of domestic output and of its factors of production in a "weak" region. Considering that most potential EMU participants are faced with considerable price rigidities, at least in comparison with the Anglo-Saxon countries and Japan, and keeping in mind that migration of labour remains limited even within individual European states, but particularly across borders, the conclusion seems inescapable that the European Union needs to develop some fiscal transfer mechanisms to protect countries hit by specific unfavourable disturbances in a way that is better than the countries themselves can do it through their remaining budgetary room for manoeuvre.

This line of reasoning has received support through a number of analyses in the recent year where the EU is compared to large existing federal states such as the United States, Canada, Australia and Germany. A comprehensive survey of the experience in these countries and their implications for the EU has been presented by the European Commission, assisted by a team of independent experts (see European Commission 1993).

A decisive question for evaluating whether EMU would become substantially more robust through the introduction of such mechanisms, is the likely size of country specific disturbances compared to experiences in for example the United States. Starting with Sachs and Sala-i-Martin (1992), followed by *i.a.* Bayoumi and Eichengreen (1993) and von Hagen and Hammond (1995), these studies tend to conclude that country-specific disturbances in the European Union have been of approximately the same order of magnitude as in those 8 to 9 regions into which the United States can naturally be divided. But the fiscal transfer mechanisms in the United States are much

stronger, particularly through the federal income tax. Early studies suggested that as much as 40% of a declining incomes in a region subjected to a specific disturbance might be absorbed in the US variant of fiscal federalism. Other studies, e.g. Gros and Thygesen (1996), indicate that this is a major overestimate, since it does not distinguish the element of stabilization policy from the American efforts at equalizing also income levels between regions and individual states; the correct level for the stabilization impact is probably only around half of the 40%, if one succeeds in isolating the dampening effect on temporary fluctuations in economic activity. It remains nevertheless that the insurance mechanism against asymmetrical disturbances is much more developed in the United States than in the European Union where the limited efforts have so far been concentrated more on the distributional effects of transfers through the Union budget, in particular through the structural funds. There is an *a priori* assumption that participants in EU have a need for a fiscal transfer mechanism in order to make the monetary union more robust, see *i.a.* Muet (1995).

Calculations produced by the European Commission (1993) concerning the costs of designing a well-targeted system of automatic transfers to absorb country-specific disturbances suggest that this could be done at much lower costs than in the United States. In a contribution to the Commission study mentioned by Italiener and Vanheukelen it is suggested that an approximately similar effect in terms of stabilization policy as that obtained through the American system could be achieved by using only 0.2% of the Union's GDP for resource transfers to member states which in the individual year face an evolution of the national rate of unemployment which is less favourable than the average for the member states to be financed by a proportional contribution from those member states where unemployment develops more favourably than the average. If countries are faced with temporary disturbances there will be no permanent receivers or contributors in the system, but this has to be monitored in order to assure that in cases of more permanent disturbances there is an adjustment of a more fundamental character through a fall in the real income in the country.

It is not evident that a fiscal transfer mechanism will be necessary in order to assure the functioning of EMU, but the subject should by now be finding its way to the agenda of the official bodies particularly since the costs do not seem immediately prohibitive, even though one has to recall that the EU had great difficulties in reaching agreements on the latest budget reform which over a five-year period only raised the revenue of the Union by approximately 0.1% of GDP. Many policy makers will undoubtedly find that even an enlargement of the EU budget by 0.2% is an insurmountable obstacle. One should not overlook either that contributions from the individual member state (and the transfer received in the country hit by an unfavourable disturbance) may be considerably higher in any single year than the 0.2% of the national GDP. It should also be recalled that the rate of unemployment despite all efforts to develop standardised methods of reporting does not have the same degree of precision as the economic indicators which have been chosen for the nominal convergence criteria. This by the way is an important argument for excluding the unemployment percentage from the formal criteria in the Treaty. Since the present proposal does not look at the level of the unemployment percentage but is targeted only at changes from year to year this particular objection seems less important in the present context, but the argument against remains that even changes in unemployment have an important non-conjunctural element.

In summary, there are arguments in favour of strengthening the capacity of individual member states to absorb the effects of country-specific disturbances in EMU better than they can do on their own through national budgetary policies, given the constraints on the latter in the Maastricht Treaty. But considering the relatively modest likely magnitude of such country-specific disturbances and the difficulties of designing criteria for transfers in a clear way these arguments are not in themselves decisive. If a fiscal transfer mechanism has to be developed, the study by the European Commission (1993) undoubtedly gives the best available starting point and some expectation that a mechanism could be designed at more modest costs than is normally assumed. An agreement to introduce such a mechanism does not necessarily require changes in the Treaty. One might consider – as was the case when the structural funds were introduced in 1988 – to limit oneself to an agreement on the medium-term EU budget.

Does EMU require more political integration?

It is tempting to answer No without any qualifications. It is not mandatory to take further steps towards a political union in order to make EMU work. Indirectly EMU will promote what may be called a Europeanisation of the public debate on economic policy. It will no longer be relevant to criticise the national central bank for its interest-rate policy, or to attack the German Bundesbank. Discussions about monetary policy and on exchange relationships to non-participants and third countries will, after the start of EMU, have to be conducted with the ECB, or possibly Ecofin in a European context. In connection with a steadily deepening integration of goods markets and financial markets other aspects of stabilization policy will also be evaluated at the European level. One should not on this background underestimate the potential for Ecofin and the European Council without formal changes to develop into more cohesive collegiate bodies which in an effective way can formulate views about guidelines for economic policy as a natural counterpart to the ECB. This will indeed be required if major tensions arise between the common monetary policy and the aggregate of the national budgetary policies of member states – a distortion of the policy-mix. But even here the convergence criteria in the Treaty, and particularly if these are modified along the lines discussed above, should help to dampen any such conflict.

There is a clear need that countries which find the EMU construction unbalanced without significant further political integration define what they really mean by "political union". If one listens to part of the debate in Germany and in other circles where supporters of a federalist structure for the European Union prevail, the main content of this concept appears to be that other areas of "high politics" – here it is common to mention foreign policy and external and internal security (the two other so-called pillars in the Maastricht Treaty) – should also be placed at the European rather than the inter-governmental level. Even though the issue of national monies and the existence of an independent foreign and security policy are often portrayed as the decisive dimensions of national sovereignty it is not obvious that there is a need for a parallel development of these two, in substance unrelated areas. It would appear more natural that a transfer of decision-making from the

national to the European level be evaluated on the basis of the strength of arguments within the areas in question. Such arguments are much more well-rehearsed and convincing in the monetary area even though many observers also find them adequate in the foreign and security policy area. These latter areas must – as will also happen in the inter-governmental conference – primarily be evaluated on their own merits.

In the German debate there is a tendency to see the desirable evolution in monetary integration and the move towards political union as parallel from the perspective that for Germany there is a basic bargain. In order to give up monetary autonomy and the D-Mark with more uncertain gains for Germany than for other member states, Germany should according to this view insist on significant progress towards political union which from a German view has a higher priority. One may add the remark that this formulation underestimates the German interest in EMU itself, in particular through the confidence in stable exchange rates *vis-à-vis* the most important trading partners of Germany which only EMU can give today, but also that the plans for a political union in a broader sense demand a lot more preparation and political ripening than what is compatible with immediate linkage of these issues.

Other partisans of evolving the EU in a federal direction have also – in correspondence with the traditions of early phases of integration since Jean Monnet developed his strategy for spill-over effects from successful integration in one area to other areas of policy – seen an important role for a monetary union as a wedge for a more general political union. It is more than doubtful, however, whether such a neo-functionalist approach can be applied to the very important policy areas here in question. There may well be the negative linkage that a failure to implement EMU after nearly a decade of preparations cannot avoid having harmful effects also for the possibilities of strengthening cooperation in other essential, but not directly linked, areas, but EMU is unlikely on its own to pull the latter to the same level of integration.

The perspective is somewhat different if one poses the question in terms of a political union defined primarily as an extension of budgetary policy coordination in the union with a view to making monetary union more functional and robust. Here the linkage is much stronger, though still not tight enough to justify the set-up of a political decision-making centre for the non-monetary part of stabilis-

ation policy, an economic government for the European Union as some French proponents, most recently Jacques Delors, have said.

In this respect the EU is close to an important decision as will already have been made clear implicitly from the above comments. If one believes that a modification of the convergence criteria – more precise rules for debt reduction, interpretation of the deficit criterion towards an average and structural definition, and a higher degree of automaticity in the application of sanctions – is desirable in order to assure the stability of monetary union, that does not suffice to justify that political union in the sense of a strong federal authority in the budgetary policy area is required. All these changes can in principle be implemented through the adoption of clear rules for cooperation whether in the form of changes in the Treaty or by supplementary agreements at the time of the start of the third stage of EMU. The proposed changes should all be regarded as changes in the framework or the norms for cooperation which Ecofin will subsequently be charged with monitoring. The changes do not presuppose new transfers of sovereignty to the federal level in order to enable the latter to make regular discretionary decisions about budgetary policies in individual member states. It is only in this latter situation that one can truthfully speak about a political union. Such a construction would imply more possibilities of conflict between member states and potentially destabilising compromises and log-rolling among the latter as is well-known from amongst others the federal budgetary process in the US.

In a recent article von Hagen (1995) underlines this perspective strongly: a monetary union may be underpinned either by norms which still leave the important parts of national budgetary authority in national hands, or by a political union where essential discretionary authority over the budgetary policies of member states, possibly also an enlarged federal budget, are placed in the hands of a "European Economic Government". There may be a high degree of substitution between these two forms of integration from the viewpoint of the potential economic effects, but the latter presupposes a much stronger deepening of mutual political understanding than is today available among the potential candidates for EMU.

It is therefore natural to put considerable emphasis on testing the limits of the applicability of the first norm-based methods before one tries to assemble more authority in Ecofin and the European Council. A framework established through clearer rules for national

budgetary policies would also be more in line with traditions in the EU in other areas where explicit rules – for want of a better expression one may use the German "Ordnungspolitik" – have normally been preferred to the collection of wide-ranging authority to undertake detailed interventions and discretionary decisions at the European level. Application of these principles to budgetary policies is also the method which appears to be best suited to assure a monetary union based on price stability. Monetary policy is an exception to the general principle of decentralization subject to rules; it seems reasonable to collect monetary authority and occasionally exercise it in a discretionary way within the framework of a long-term stable policy. But this is not an example to be followed in the area of budgetary policies.

Conclusion

The frequently voiced criticism that the Maastricht Treaty contains an unreasonable degree of asymmetry by gathering all monetary authority in EMU in an independent central bank while leaving fiscal policy as a predominantly national matter is not well founded. This criticism cannot find support in the fact that the first effort to create EMU – the Werner plan of 1970 – did accept the idea that centralizing budgetary policy competence as well was desirable. The perspective in EMU will not in the first instance be to attempt any detailed demand management through coordinated budgetary policies. The room for manoeuvre in national budgetary policies had already been used to the limit when the Treaty was signed – and that remains true. There is, anyway, too much uncertainty and disagreement as to how demand management works even when the measures are coordinated in order to leave any active role for it for a long time. The important perspective is rather how EMU can become a constructive framework for the efforts at correcting large budgetary imbalances and high debt which form the legacy of the 1980s and early 1990s as the starting point of the third stage in EMU. All participating countries will over the next decades be faced with the task of consolidating their public finances and introducing reforms in the principles of transfer payments etc., and in containing the public sector in time before further

growth in public debt and demographic factors complicate these already difficult tasks – as will happen in several European countries shortly after the change of the century. It is important that the EU member states handle this task in a roughly convergent fashion without preventing countries from choosing specific national solutions in correspondence with their preferences. With this objective in mind, the convergence criteria of the Maastricht Treaty are not inappropriate; if anything, they are too vague. They could be made more precise through supplementary interpretations in areas where the rules are either without substantive content – as is the case for the request to reduce debt at a "satisfactory pace" – or more arbitrary and mechanical than necessary – as is the case for the reference value of 3 per cent for public sector deficits in an arbitrary year. It is also possible that the scope for imposing sanctions on countries with a deviant budgetary policy should be made more precise by introducing more automaticity and shorter time lags.

There are arguments in favour of supplementing EMU by elements of fiscal federalism – even though it is hard to be confident that their absence undermines the union. Official bodies should begin to address themselves to the task of introducing a fiscal transfer mechanism in order to protect participants better against the effects of unfavourable country-specific shocks of a temporary nature as proposed by the European Commission study of 1993.

The implementation of EMU does not in itself obviously require further political integration. The concept of political union is imprecise unless a discussion is confined to elements which are closely related to the functioning of monetary union, but in this area a norm-based cooperation building on the convergence criteria, preferably modified as suggested above, constitute an attractive alternative to centralization of political authority over budgetary policy at the EU level. Such a centralization is likely to overload cooperation and would imply greater dangers than benefits for monetary stability.

REFERENCES

BAYOUMI, TAMIN and BARRY EICHENGREEN (1993), "Shocking aspects of European Monetary Integration", in Torres, Francisco and Francesco Giavazzi eds, *Adjustment and Growth in the European Monetary Union*, Cambridge University Press, Cambridge.

BUITER, WILLEM, GIANCARLO CORSETTI and NOURIEL ROUBINI (1993), "Excessive deficits: sense and nonsense in the Treaty of Maastricht", *Economic Policy*, 16, pp. 57-100.

DELORS, JACQUES (1989), *Report on the Study of Economic and Monetary Union in the European Community* (Delors Report), European Communities, Luxembourg.

EUROPEAN COMMISSION (1993), "The economics of community public finance", *European Economy*, Special Issue 5, Brussels.

EUROPEAN COMMISSION (1995), "1995 broad economic policy guidelines", *European Economy* no. 60, Brussels.

GROS, DANIEL *et al.* (1996), *Towards Economic and Monetary Union: Problems and Prospects*, Report from the CEPS Economic Policy Centre for European Policy Research, Brussels.

GROS, DANIEL and NIELS THYGESEN (1996), "The relationship between economic and monetary integration: EMU and national fiscal policy", in *European Monetary Integration: From the EMS to EMU*, Longman, London (forthcoming).

HUGHES HALLET, ANDREW and Y. MA (1990), "The dynamics of debt deflation in a monetary union", *Journal of International and Comparable Economics* (forthcoming).

JENKINS, ROY (1977), "Europe's present challenge and future opportunity", *Jean Monnet Lecture*, European University Institute, Florence.

LAMFALUSSY, ALEXANDRE (1989), "Macro-coordination of fiscal policies in an economic and monetary union in Europe", paper annexed to the Delors Report.

McDOUGALL, SIR DONALD *et al.* (1977), *Report of the Study Group on the Role of Public Finance in European Integration* (McDougall Report), vols I-II, Commission of the European Communities, Brussels.

MUET, PIERRE-ALAIN (1995), "Union monétaire et fédéralisme", *Revue de l'OFCE*, no. 55, Observatoire Français des Conjonctures Economiques, Paris, pp. 151-170.

OECD (1968), *Fiscal policy for a balanced economy* (by Walter Heller *et al.*), Paris.

SALA-I-MARTIN, XAVIER and JEFFREY SACHS (1992), "Fiscal federalism and optimum currency areas: evidence for Europe from the United States", *CEPR Discussion Paper*, no. 632, Centre for Economic Policy Research, London.

VON HAGEN, JÜRGEN (1995), "Monetäre, fiskalische und politische Integration: Das Beispiel der USA", in Deutsche Bundesbank, *Auszüge aus Presseartikeln*, Frankfurt (10. November 1995).

VON HAGEN, JÜRGEN and GEORGE W. HAMMOND (1995), "Regional insurance against asymmetric shocks – An empirical study of the European Community", *CEPR Discussion Paper*, no. 1170, Centre for European Policy Studies, London.