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Winfried Horstmann*

A European Perspective on Public Debt

Public debt in Europe has risen continuously over the last two decades. How is the transition to European Economic and Monetary Union, with the increasing economic interdependence between individual member states which it involves, likely to affect this situation? Which policy issues are of particular relevance in this setting?

Member states of the European Union (EU) have accumulated large stocks of government liabilities.¹ With the exception of the United Kingdom, Ireland and Luxembourg all countries have experienced a continuous rise of the debt/GDP ratio over the last two decades. In Belgium and Italy public debt already exceeds 100% of GDP, and in both countries gross figures are approximately equivalent to net debt (Table 1). The development of interest expenses corresponds to this trend and in fact interest payments have increased in most EU countries (Table 2). Since politicians have not realized primary surpluses² to an amount sufficiently large to compensate for interest expenses, financial balances have been notoriously in deficit.

The overall rise of public debt in Europe basically reflects the impact of rent-seeking behaviour on government activity. Indeed, interest groups claim large fractions of government budgets at the expense of the entire collective of taxpayers. Furthermore, politicians and bureaucrats often act as political entrepreneurs in the sense of systematically increasing the supply of tax exemptions, subsidies or regulations in favour of specific groups in society. Both sides derive benefits from this kind of deal. On the one hand the interest groups can distribute rich funds among their members. On the other, politicians increase their chances of getting re-elected or of obtaining profitable side-line jobs in some large federation or enterprise, for example. The costs of rent-seeking activities to society show up in overconsumption of public goods, and in a waste of resources that are employed in redistributing gross national product instead of extending production facilities.³

Such costs will occur in a European Economic and Monetary Union (EMU) as well. Indeed, rent-seeking

activities, an increasing stock of government liabilities, and extended cross-border financial transfers are likely to shape the fiscal side of EMU. What would be the consequences of such developments, particularly of a persistent rise in public indebtedness in individual member states? The answer to this question is based on the stronger economic interdependence in Europe that will result from the EMU characteristics of common economic policies, one single currency, free trade, and factor mobility. In this setting changes of economic variables in individual states will affect partner countries much more directly than in the current first phase of the transition towards EMU.⁴ An integrated Europe without fiscal discipline therefore may suffer from severe economic spillover effects, as for instance:

- the erosion of the business climate,
- Union-wide crowding out of investment,
- exchange rate instabilities, and
- limited room for monetary manoeuvre.

¹ Throughout this article the expressions "government liabilities", "public debt" and "public indebtedness" are used as synonyms. The terms "public deficits", "fiscal deficits" and "financial balances in deficit" are substitutes for the "increase of public debt".

² The primary surplus (deficit) is defined as the positive (negative) difference between government revenues and spending net of interest received or paid.

³ Public choice literature has provided a variety of empirically tested theories about the determinants of rent-seeking, government activity and the evolution of public debt. See, for example, V. Grilli, D. Masciandaro and G. Tabellini: Political and Monetary Institutions and Public Financial Policies in the Industrial Countries, in: *Economic Policy* 13, October 1991, pp. 341 ff.; W. W. Pommerehne: The Empirical Relevance of Comparative Institutional Analysis, in: *European Economic Review* 1990, pp. 458 ff.; F. Schneider: The Federal and Fiscal Structures of Representative and Direct Democracies as Models for a European Federal Union: Some Ideas Using the Public Choice Approach, forthcoming in: *Journal des Economistes et des Etudes Humaines*, Paris & Aix en Provence, 1993; and B. S. Frey and F. Schneider: Politico-Economic Models of Macroeconomic Policy: A Review of the Empirical Evidence, in: T. D. Willet (ed.): *Political Business Cycles. The Political Economy of Money, Inflation and Unemployment*, Durham and London 1988, pp. 239 ff.

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Economic Spillovers

A common line of spillover effects is based on the erosion of the business climate. In the presence of persistent deficits and growing debt both investors and consumers expect rising inflation rates and future tax increases. Firms and households adjust to the expected developments by raising prices, containing private investment and reducing consumption expenditures.⁵ Thus, the national economic product grows at slower rates and employment opportunities shrink. The empirical significance of such effects depends, among other factors, on the level of public debt, on the business cycle situation, and on the type of expenditure financed by government bonds. Countries with a relatively low ratio of public debt to GDP, as for example France and Germany between 1974

and 1984 (see Table 1), can afford to compensate for sluggish domestic demand by increasing fiscal deficits over a limited time-period. If, in addition to this, governments use the revenues from issuing bonds for financing productive investment rather than short-lived consumption, investors' and consumers' confidence will even improve. This is the case of an appropriate demand management that softens cyclical fluctuations of output and employment. In contrast, if the debt/GDP ratio has already reached high levels, as is the case in many EU countries nowadays, a further rise in public indebtedness will reduce government credibility and serve as an obstacle to economic development and prosperity.

The negative consequences of excessive deficits and debt become even more critical as the structural component of the overall deficit increases. Since structural deficits reflect long-term disparities between taxation and spending rather than cyclical factors, these deficits are a particular burden to the capital market and to the business climate. According to OECD estimates structural financial balances in European industrialized countries have risen from 3.5% of GDP in 1989 to some 5.0% in 1993.⁶

Another source of spillover effects is the interaction between public sector deficits and interest rates. This argument postulates that public deficits raise the price of capital, thus bringing about Union-wide crowding out of investment in the first place. Second, a larger interest rate differential vis-à-vis the rest of the world may lead to exchange rate appreciations. This is a result of capital inflows, which occur if the Mundell-Flemming assumption of high international capital mobility holds.⁷ However, the literature does not unambiguously support the hypothesis of a link between public deficits and interest rate movements. Three different approaches have to be distinguished: the Neoclassical, the Keynesian and the Ricardian schools. In the Neoclassical setting, an increase

Table 1
Public Debt in the EEC from 1974 to 1993^a
(As a percentage of GDP)

	1974-84	1985	1990	1991	1992	1993 ^b
Belgium						
Gross public debt	79.0	122.3	130.7	133.9	136.0	141.6
Net public debt	-	111.9	119.4	121.3	123.4	129.0
Denmark						
Gross public debt	37.2	64.1	59.5	60.7	62.4	66.2
Net public debt	-	34.4	26.5	27.7	29.4	33.3
France¹						
Gross public debt	39.6	45.5	46.6	48.6	51.6	57.1
Net public debt	-	22.9	25.0	27.1	30.0	35.6
Germany^{1,2}						
Gross public debt	32.1	42.5	43.5	41.8	42.8	46.2
Net public debt	-	21.8	22.8	23.1	24.1	27.5
Greece						
Gross public debt	31.8	57.9	89.0	96.3	94.6	98.4
Net public debt	-	-	-	-	-	-
Ireland						
Gross public debt	76.0	104.3	98.7	96.7	93.8	92.1
Net public debt	-	-	-	-	-	-
Italy						
Gross public debt	60.9	84.3	100.5	104.0	108.0	114.0
Net public debt	-	81.9	99.0	102.7	106.7	112.6
Luxembourg						
Gross public debt	15.4	14.0	6.9	6.1	6.8	7.8
Net public debt	-	-	-	-	-	-
Netherlands¹						
Gross public debt	-	67.9	76.5	76.6	78.0	80.6
Net public debt	-	41.5	55.9	55.9	57.2	59.8
Portugal						
Gross public debt	39.9	66.5	66.6	67.5	62.6	67.6
Net public debt	-	-	-	-	-	-
Spain						
Gross public debt	20.1	48.8	46.8	49.3	51.4	57.4
Net public debt	-	27.6	31.6	33.9	36.0	42.0
United Kingdom						
Gross public debt	58.6	52.7	34.7	35.4	40.5	47.3
Net public debt	-	45.8	28.5	30.0	35.1	41.9

^a General government. ^b Forecasts. ¹ Excluding shares and holdings in public corporations. ² Gross public debt West Germany; net public debt in 1985 and 1990 West Germany and from 1991 on united Germany.

Sources: Commission of the European Communities: Europäische Wirtschaft 54, Brussels 1993, pp. 256 ff., for 1974-1984 and for all data concerning Luxembourg; OECD: Economic Outlook 54, Paris December 1993, pp. 154 ff., for 1985-1993.

⁴ Three phases for the transition to EMU have been mapped out. During the first phase, which was finished at the end of last year, member states were requested to design economic policies in a way that promoted economic convergence in terms of the criteria of the Maastricht treaty (inflation, interest rates, public deficits and debt, and exchange rate stability). In the second phase, which has started at the beginning of 1994, a European Monetary Institute (EMI, not to be confused with the later European System of Central Banks) shall be established and economic convergence shall be further enhanced. In the third phase full EMU will come into force. This phase is planned to start during the time period from the beginning of 1997 to January 1st, 1999.

⁵ A survey of the theory of expectations formation can be found in G. K. Shaw: Expectations in Macroeconomics, in: D. Greenaway (ed.): Current Issues in Macroeconomics, Houndsmill, Basingstoke, Hampshire and London 1989, pp. 21 ff.

⁶ See OECD: Economic Outlook No. 54, Paris, December 1993, p. 15.

⁷ For a comprehensive Mundell-Flemming approach see J. A. Frenkel and A. Razin: The Mundell-Flemming Model a Quarter Century Later, in: Staff Papers, International Monetary Fund, 1987, pp. 567 ff.

in public deficits reduces aggregate saving, hence bringing about higher interest rates.⁸ The traditional Keynesian school accepts the link between interest rates and budget deficits if the economy is not caught in the "liquidity trap".⁹ Since deficit spending is assumed to bring about increasing national income and full employment, the economy shifts out of the liquidity trap if the government spends more than it collects from the taxpayers. This results in higher interest rates as long as monetary policy does not accommodate.

The Ricardian approach brings about different results. According to this school, rising public sector deficits generate a compensating increase of private saving.

Table 2
Financial Balances and Interest Expenses
in the EEC from 1974 to 1993^a
(As a percentage of GDP)

	1974-84	1985	1990	1991	1992	1993 ^b
Belgium						
Financial balances	-8.3	-8.8	-5.7	-6.5	-6.8	-7.0
Interest expenses	6.2	10.8	10.9	10.6	10.9	10.3
Denmark						
Financial balances	-2.9	-2.0	-1.5	-2.2	-2.5	-4.3
Interest expenses	4.0	9.9	7.3	7.3	6.9	7.2
France						
Financial balances	-1.6	-2.9	-1.5	-2.1	-3.9	-6.0
Interest expenses	1.6	2.9	2.9	3.1	3.2	3.3
Germany¹						
Financial balances	-2.9	-1.1	-2.1	3.2	-2.6	-4.0
Interest expenses	2.0	3.0	2.6	2.8	3.1	3.2
Greece						
Financial balances	-	-14.0	-18.1	-14.4	-11.1	-14.8
Interest expenses	2.4	5.3	11.9	12.8	14.6	14.5
Ireland						
Financial balances	-10.9	-10.1	-1.5	-1.4	-2.6	-3.2
Interest expenses	6.6	10.3	8.2	8.0	7.2	7.2
Italy						
Financial balances	-9.3	-12.6	-10.9	-10.2	-9.5	-9.7
Interest expenses	5.4	8.0	9.6	10.2	11.5	12.6
Luxembourg						
Financial balances	1.4	6.2	5.0	-0.8	-0.4	-1.0
Interest expenses	1.2	1.1	0.6	0.6	0.5	0.5
Netherlands						
Financial balances	-3.9	-3.9	-5.1	-2.6	-3.5	-4.1
Interest expenses	3.9	6.3	6.0	6.2	6.2	6.2
Portugal						
Financial balances	-	-7.4	-5.3	-6.0	-4.6	-8.2
Interest expenses	3.3	7.9	8.1	8.5	9.1	7.9
Spain						
Financial balances	-2.4	-6.9	-3.9	-5.0	-4.5	-7.2
Interest expenses	0.8	3.1	3.5	4.0	4.3	4.7
United Kingdom						
Financial balances	-3.6	-2.9	-1.3	-2.7	-6.2	-8.2
Interest expenses	4.5	5.0	3.4	3.0	3.1	3.8

^a General government. Negative sign of financial balances indicates deficit. ^b Forecasts. ¹ Up to 1990 West Germany, 1991 to 1993 united Germany.

Sources: Commission of the European Communities: *Europäische Wirtschaft* 54, Brussels 1993, pp. 256 ff., for interest expenses, for financial balances 1974-1984, and for all data concerning Luxembourg; OECD: *Economic Outlook* 54, Paris December 1993, p. 150 for financial balances 1985-1993.

Therefore, in a world of Ricardian equivalence, "desired national saving does not change, the real interest rate does not have to rise ..., there is no effect on investment ..."¹⁰ However, the Ricardian equivalence (or debt neutrality) theorem is based on a set of very strong assumptions, such as infinite lifetime or overlapping generations, perfect capital markets, lump sum taxation, correct information about the size of the discount rate, and certainty about the timing and amount of future taxation. Because of these critical assumptions the Ricardian approach has a weak explanatory power only. In fact, current research does not support the debt neutrality theorem. Simulations with the OECD Interlink Model indicate a positive relationship between fiscal deficits and the short-term interest rate.¹¹

The line of reasoning that has been applied so far yields the conclusion that a correlation between public sector deficits and interest rates cannot be denied. However, the question of causality between these two variables hitherto remains unanswered. A recent co-integration approach that is based on the method of Engle and Granger sheds some more light on this issue. According to this contribution,¹² causality between public deficits and interest rates in various European countries is bidirectional: not only do fiscal deficits affect interest rates, the reverse chain of reaction holds as well. Naturally, the impact of interest rate increases on public debt is the stronger, the larger the stock of government liabilities. This relation is of importance for the interaction between monetary and fiscal policies in an EMU. If the forthcoming European System of Central Banks (ESCB) chooses a high level of interest rates in order to contain inflation, those EMU countries which have accumulated large stocks of public debt will face a substantial increase in interest expenses on outstanding bonds. In such a situation, public deficits and debt would grow even faster, and as a result the ESCB would come under increasing pressure to ease monetary policy. The highly indebted countries would probably try to mobilize their representatives in the ESCB's council in order to get them

⁸ See B. D. Bernheim: *A Neoclassical Perspective on Budget Deficits*, in: *The Journal of Economic Perspectives* 3, Spring 1989, pp. 55 ff.

⁹ See W. H. Branson: *Macroeconomic Theory and Policy*, third ed., New York 1989, pp. 154 ff.

¹⁰ See R. J. Barro: *The Ricardian Approach to Budget Deficits*, in: *The Journal of Economic Perspectives* 3, Spring 1989, p. 39.

¹¹ See S. Englander and T. Egebo: *Adjustment Under Fixed Exchange Rates: Application to the European Monetary Union*, in: *OECD Economic Studies* 20, Spring 1993, pp. 17 ff.

¹² See W. Horstmann and F. Schneider: *Deficits, Bailout and Free Riders: Fiscal Elements of a European Constitution*, paper presented at the Annual Meeting of the European Public Choice Society 1994 in Valencia.

arguing in favour of lower interest rates and more inflation.¹³

EMU will provide new incentives for loosening the stance of fiscal policies. Interest rate effects, the crowding out of investment, exchange rate instabilities and a deteriorating business climate, which arise from unsustainable fiscal policies in one country, will be fractionalized and spread over the entire EMU. The strongest factor behind such fractionalization is the EMU property of one single currency. Government bonds issued by one country increase the total stock of public debt that is denominated in the common currency. The particular country which produces the fiscal disturbance therefore takes only a small proportion of the negative effects on economic development, or, in other words, the "marginal cost of overborrowing by a country" decreases in an EMU.¹⁴ As a natural reaction governments will aim at applying free-riding strategies¹⁵ in the sense of taking advantage of the political benefits lower taxes or increased public spending can bring about on the one hand, and passing on substantial proportions of the debt induced negative effects to their partners on the other.

In addition to this, political cohesion in the EMU would establish a certain moralistic responsibility for granting financial assistance to partner countries in need. Member states can hardly refuse to support countries that suffer from excessive government deficits and debt.¹⁶ Therefore, the volume of cross-border financial transfers is likely to

become larger in an integrated Europe. To go one step further, such transfers could even experience a sudden drastic increase, given a critical rise in the default risk on government debt in some highly indebted countries.¹⁷ Under such circumstances capital markets might no longer be willing to provide funds to these countries – at least not at a reasonable price – and EMU partners would then have to bail out unsustainable deficits. A popular argument against this line of thought stresses the point that the Maastricht treaty explicitly excludes bail out operations (Article 104b). However, as a result of political pressure and economic spillover effects the large-scale financing of unsustainable deficits via cross-border financial transfers could materialize.

Further incentives for increasing cross-border financial transfers may arise from the redistribution of seignorage in an EMU. At the current stage EU member states are issuing their own currencies thereby collecting revenues that specifically arise from the creation of base money, i.e. seignorage or the inflation tax. In an EMU, however, seignorage will get lost as a national source of revenue, because the ESCB will collect the inflation tax. Hence, political negotiations about the allocation of seignorage will emerge, and once the bargaining is in process member states probably will try to attract a maximum amount of financial transfers from the European authorities. Although, from a theoretical point of view, the seignorage

¹³ See R. Vaubel: Die politische Ökonomie einer Europäischen Zentralbank. Probleme und Lösungsvorschläge, in: P. Bofinger, S. Collignon and E.-M. Lipp (eds.): Währungsunion oder Währungschaos?, Wiesbaden 1993, pp. 60 ff.

¹⁴ See C. R. Bean: Economic and Monetary Union in Europe, in: The Journal of Economic Perspectives 6, Fall 1992, p. 46.

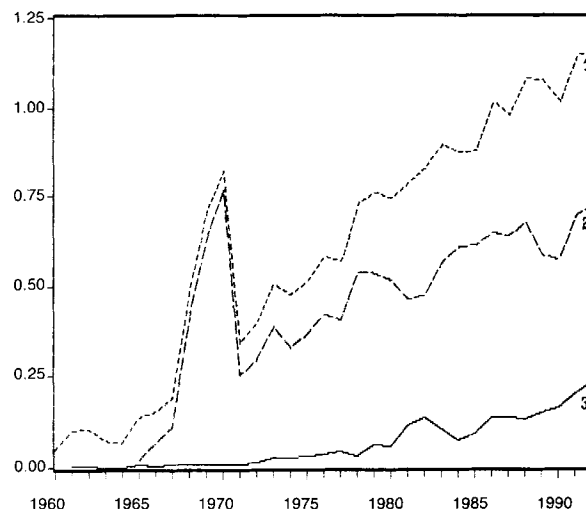
¹⁵ See N. Berthold: Der Weg zur Europäischen Währungsunion – Überwindbare Hindernisse?, in: Außenwirtschaft 47, 1992, p. 185; and M. J. M. Neumann: Internationale Wirtschaftspolitik: Koordination, Kooperation oder Wettbewerb?, in: Schriften des Vereins für Socialpolitik, Neue Folge 120, Berlin 1991, p. 73.

¹⁶ See D. Duwendag: Budgetpolitik, Kapitalmärkte und Kapitalallokation: Implikationen für die Europäische Wirtschafts- und Währungsunion, in: C. Köhler and R. Pohl (eds.): Währungspolitische Probleme im integrierten Europa, Veröffentlichung des Instituts für empirische Wirtschaftsforschung 29, Berlin 1992, p. 80.

¹⁷ As Alesina et al. have found the current default risk on government debt in the industrialized countries is rather small. However, as public debt in the EU is predicted to experience a further rise, the situation could change significantly. Given such circumstances the markets could drastically increase the risk premium for the highly indebted countries. See A. Alesina, M. De Broeck, A. Prati and G. Tabetlini: Default Risk on Government Debt in OECD Countries, in: Economic Policy 15, October 1992, pp. 427 ff.

¹⁸ A common approach to measuring seignorage is the opportunity cost concept. According to this concept the amount of seignorage is equivalent to the revenue loss the private sector experiences as a result of foregone interest earnings on base money. Since the government does not pay interest on the creation of base money it is able to realize revenue gains by issuing currency. Methodological problems arise because the correct interest rate can hardly be identified. See M. Klein and M. J. M. Neumann: Seignorage: What is it and Who Gets it?, in: Weltwirtschaftliches Archiv 126, 1990, pp. 205 ff.

Figure 1
Outlays of the European Commission
from 1960 to 1992
(As a percentage of GDP)



¹ Total expenditure. The value for 1992 does not include outlays of the European Development Fund. ² Spending for common agricultural policies. ³ Social and regional funds. Regional funds were established in 1975.

Sources: Commission of the European Communities, Europäische Wirtschaft 54, Brussels 1993, p. 202 and p. 252; own computations.

problem has strong implications, one should bear in mind that the quantitative dimension of the inflation tax is somewhat difficult to determine.¹⁸ The European Commission has calculated some figures saying that seignorage in Greece, Italy, Portugal and Spain accounted for 2.8%, 1.1%, 2.2% and 1.3% of GDP respectively in 1988. In the northern states of the EEC the inflation tax did not exceed a value of 0.6% of GDP.¹⁹

Bureaucracy and European Outlays

Bureaucracies tend to expand in the long run. Indeed, bureaucrats normally are interested in increasing the budgets, staff and competences of the organizational units they are heading and working for.²⁰ This rule seems to apply to the European authorities as well, although increased budgets and competences of the European Commission are to some extent a desirable and inevitable consequence of European integration. As Figure 1 shows, Brussels' expenditures as a percentage share of GDP have substantially risen over the past three decades. Although this development is not a major cause of the debt problems of member states, one can identify growing European outlays as one source of rising public debt in those countries which are net contributors to the European budget. These countries hardly cut domestic spending for the purpose of transferring financial resources to Brussels. Therefore, expenditures at the European central level have become additional spending rather than substitutes for national activities.²¹

The bulk of European outlays results from the common agricultural policy with its costly protection of overproduction via regulated prices and massive subsidization. More than 90% of the total European budget was spent on this in 1970, and in 1992 still some 60% of

European funds were devoted to subsidizing the agricultural sector. Obviously, farmers have formed well-organized lobbies that have successfully claimed financial assistance.²² This observation gives rise to the question as to whether interest groups may become even more powerful in an EMU. The answer has to take into consideration the competences of a future European government. Such a government will be responsible for policy action and regulation in many fields, as for instance trade policy, foreign affairs and European defence. Self-interested bureaucrats that are in search of new opportunities for promoting centralization will probably take advantage of this constellation. Both the central budget and the number of administrators employed by the European authorities will therefore expand over time. This means the funds "available" for lobbying activities at the central level grow, while the national authorities probably will not compensate for this development. Again, the final outcome shows up in higher debt figures and additional financial transfers, this time from member states to the central government.

The European Commission's recent request for permission to issue "Union Bonds" is a good example of a bureaucracy's struggle in favour of increased budgets and competences. The approval of this proposal (which was put forward in the Commission's 1993 White Paper) by member states would open up the gates for additional public sector spending in Europe. The result would be an increase of total public debt in the Union.

One possible way of avoiding the spillover effects mentioned above is to introduce mechanisms that help to harmonize fiscal policies in Europe. This is the case for subjecting deficits and debt to binding guidelines. However, various objections to this approach have been expressed. First, harmonized budgetary rules are often regarded as an instrument designed at reducing national autonomy. Second, it is suspected that fiscal policies would take a deflationary path if such rules were introduced.²³ Third, some critics argue that binding guidelines are not necessary because a monetization of public debt would not come into effect in an EMU.²⁴ Fourth, and most important, the critics hypothesize that the "power of the market" would impose a disciplinary device on national fiscal policies. The argument postulates that national authorities were determined to keep fiscal policies on a sustainable path in order to promote growth and to widen employment opportunities.²⁵

However, the assertion that politicians design fiscal plans under consideration of market forces is based on rather weak grounds. First, political decisions in the European democracies are regularly evaluated in elections, and the outcomes of such elections are based

¹⁸ See Commission of the European Communities: *One Market One Money*, European Economy 44, Brussels 1990, p. 121.

²⁰ See R. Vaubel: *The Political Economy of Centralization and the European Community*, revised version of a paper presented at the 19th Karl Brunner Conference on Liberty, Analysis and Ideology, Interlaken, June 1992, p. 3.

²¹ From a fiscal point of view such a substitution would have been useful, because it would have helped to contain public debt in member states. However, any shift of national government activity and regulation to the European level should be in line with the requirements of subsidiarity.

²² On this see, for example, the general explanation by M. Olson: *The Rise and Decline of Nations. Economic Growth, Stagflation, and Social Rigidities*, New Haven and London 1982, pp. 43 ff.

²³ This argument has been put forward by W. Buiter, G. Corsetti and N. Roubini: *Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht*, in: *Economic Policy* 16, April 1993, pp. 75 ff.

²⁴ See H. Lehment and J. Scheide: *Die Europäische Wirtschafts- und Währungsunion: Probleme des Übergangs*, in: *Die Weltwirtschaft*, 1992, p. 53.

²⁵ See Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft: *Europäische Währungsordnung, Gutachten*, Bonn 1989, pp. 22 ff.

on a range of policy issues, of which the economic situation is only one. Second, as has been explained above, EMU may provide leeway for applying free-rider strategies that lead to an overall rise in government deficits and debt. Third, one can observe a strong historical increase in public indebtedness in various industrialized countries that hinders economic development. This does not fit the hypothesis that the power of the market exerts control over the budget. Finally, traditional rent-seeking activities, which are significantly contributing to the current levels of the debt/GDP ratio in EU states, will live on in EMU. Usually, such activities are not subject to market forces.

Constitutional rules that subject public deficits and debt to upper limits are appropriate tools for containing the stock of government liabilities. The Maastricht treaty provides such rules. According to Article 104c and the "Protocol on the Excessive Deficit Procedure", deficits should not account for more than 3% of GDP, and public debt should not exceed a proportion of 60% of GDP. At first glance these reference values seem to be rather tight, because they would force many EMU countries to implement drastic spending cuts and tax increases. However, a more detailed analysis illustrates that the Maastricht criteria are not binding. EMU countries can easily be exempted from meeting the criteria, for example, if the "ratio of the planned or actual government deficit to gross domestic product ... has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value". As far as the ratio of government debt to GDP is concerned, the benchmark of 60% is not binding if "... the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace". Although these escape clauses seem to be necessary in order to introduce some flexibility into the rigid system of reference values, they should only be applied in a very cautious way. In any case the clauses should not be misused for justifying persistent fiscal profligacy.

Conclusions

The line of thought that has been developed so far raises a bundle of important policy issues. In the current political setting five aspects of particular relevance should be kept in mind:

First, the Maastricht convergence criteria concerning the size of national deficits and debt, inflation, interest rates, and exchange rate stability should be applied

resolutely. This requires, among other factors, careful supervision of member states' fiscal policies on the one hand, and a deliberate use of the escape clauses on the other.

Second, the European authorities should not be allowed to accumulate debt in order to avoid additional debt dynamics that would come into effect if "Union Bonds" were introduced.

Third, Article 104b of the Maastricht treaty which excludes bailout operations should be interpreted in a strict way. This would help to block free-rider behaviour by member states which otherwise may strategically aim at attracting financial transfers.

Fourth, tighter control over firms and farmers that take advantage of European subsidies would reduce the waste of resources. Various cases of fraud with European funds have been discovered over the past few years, and the marginal benefits of increased supervisory activities seem to be larger than the marginal cost.

Fifth, the European Internal Market should be completed. Not only would this contribute to economic growth and employment in Europe, it would also help to increase the mobility of capital and labour. The latter effect is of particular importance, because forming a currency union means abolishing the exchange rate as a shock absorber. Asymmetric shocks can therefore hit individual EMU countries much harder than at the current stage, where exchange rates are allowed to float in a fluctuation margin of + /-15% around their central parities. If labour were immobile and wages were sticky in an EMU, asymmetric shocks would produce regional unemployment that would probably be financed via horizontal or vertical transfers.²⁶ This, however, would increase public deficits and debt and place additional burdens on European taxpayers.

The aspects mentioned above are in line with the rules laid down in the Maastricht treaty. Over the medium term, however, member states may find that political, economic and monetary integration requires additional institutional arrangements, e.g. a detailed European constitution. In this case politicians should bear in mind that full benefits from EMU can be derived only if constitutional rules reduce the leeway for overborrowing. This requires, among other things, a precise definition of government liabilities as well as binding ceilings for public deficits and debt.²⁷

²⁶ See R. Mundell: A Theory of Optimum Currency Areas, in: American Economic Review, 1961, p. 657.

²⁷ Some ideas for a European fiscal constitution have been put forward already. According to recent proposals a European Union should not be allowed to accumulate debt, for example. See e.g. European Constitutional Group: Für Europa eine Verfassung der Freiheit, in: Frankfurter Allgemeine Zeitung 199, 1993, p. 11; and W. Horstmann and F. Schneider, op.cit.