Reforming Europe’s stability and growth pact: Lessons from the American experience in macrobudgeting

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ABSTRACT

Proposed and actual reforms to the European Union (EU) Stability and Growth Pact commonly retain the Pact’s deficit and debt targets. The American experience with similar macrobudgetary rules suggests that deficit targets may actually act as an incentive for political leaders to engage in noncompliant behavior. If targets were revised to budgetary objectives that politicians could achieve more easily and claim credit for accomplishing, compliance with the new macrobudgetary rules might be increased.

KEYWORDS

Balanced budgets; Economic and Monetary Union; European Commission; European Union; Excessive Deficit Procedure; Maastricht Treaty; Public Finance; Stability and Growth Pact; Treaty on European Union; United States.

1. INTRODUCTION

Governments of industrialized societies have struggled to keep their public finances under control since the oil shocks and stagflation of the 1970s. The Thatcher government reformed the United Kingdom’s public finances, the Japanese adopted the Fiscal Structural Reform Act of 1997 to control their growing deficits, and after years of budgetary conflict the governments of Canada and the United States (US) balanced their budgets in 1997 and 1998 (Savage, 2000). When conceptualizing the creation of Economic and
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Monetary Union (EMU) in the early 1990s as part of this broader effort at inducing fiscal restraint, European member states included in the Treaty on European Union (TEU), also known as the Maastricht Treaty, the famous ratio of debt to gross domestic product (GDP) of 60 percent (then the average of the member states), and a annual budgetary deficit as a ratio of GDP of 3 percent (a reference value agreed to by member states representatives) as key convergence criteria for determining EMU membership (Verdun, 2000). In 1997 European Union (EU) member states supplemented the TEU with the Stability and Growth Pact (SGP), which provided for a number of clear steps with deadlines and possible penalties if member states failed to comply with the TEU’s fiscal rules. By late 2003, however, this system of fiscal constraint verged on the brink of collapse (Heipertz and Verdun, 2003, 2005, 2006). In the intervening years, the EU continues its search for a politically acceptable compromise to keep its fiscal rules intact while improving their efficiency and effectiveness in gaining member state compliance.

Can the SGP be reformed to improve EU member state compliance with its budgetary provisions? The Pact is widely criticized as economically unnecessary, fiscally counterproductive, and simply politically ineffective, as a significant number of member states violate the three per cent ceiling on budgetary deficits years following the introduction of euro banknotes and coins. Public criticism includes European Commission President Romano Prodi’s famous description of the SGP as ‘stupid’, (Financial Times, 22 October 2002). Others characterize the SGP as ‘an empty shell’ and call for doing away with the law (Eichengreen and Wyplosz, 1998; Enderlein, 2004; Gros et al., 2005; Posen, 2005a,b). The SGP’s defenders, meanwhile, point to the overall fiscal restraint of the euro area and the valuable role the SGP plays in macroeconomic coordination (Artis and Buti, 2001; Beetsma, 2001; Buti and Giudice, 2002; Buti and Pench, 2004). Regardless of the status of this debate, the SGP stands as EU law, firmly embedded in the Treaty on European Union and EU secondary law, and the member states remain committed for the foreseeable future to the basic architecture of EU fiscal policy coordination (Heipertz and Verdun, 2005, 2006).

The EU’s determination to maintain some version of the SGP is reflected in the reforms adopted in March 2005 by the Council of Ministers on Economic and Financial Affairs (ECOFIN). ECOFIN’s revisions retained the SGP’s budgetary targets, including the three percent of GDP excessive deficit threshold; emphasized the role of cyclically adjusted deficit calculations; declared that the member states should avoid procyclical fiscal policies; affirmed that the administrative and statistical capacity of the Commission be strengthened for purposes of the surveillance process; and elevated the importance of the member states’ debt levels in evaluating their compliance with the SGP. The reforms also expanded the conditions under which the member states could exceed the three percent deficit level

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and increased the number of months from four to six during which they could take corrective measures (Council of the European Union, 2005). Despite these reforms there continues to be significant breaching of the three percent ceiling on budgetary deficits as a percentage of GDP, even under the more flexible rules agreed upon in March 2005. On 23 October 2006, the European Commission issued its formal report on the compliance of the member states with the SGP in 2005. One-third of the original 15 states ran deficits in excess of 3.0 percent of GDP, as did four of the ten newest EU member states. Successful compliance with the SGP is more than simply avoiding excessive deficits. The Pact calls for the member states to adhere to a medium-term objective of budgetary positions of close to balance or in surplus. Only nine of the 25 member states and three of the 12 member states in the euro area complied with this standard (Eurostat, 2006). More importantly, since 2004 the economic cycle has been in an upswing, which means that achieving the budgetary rules is currently much easier than a few years ago at a time of recession. It is widely held that the real test of the SGP will come when another major economic downturn occurs in Europe. The fact that the SGP has proved itself unable to ensure that member states will comply with the budgetary deficit rules at a time of economic recession or even economic recovery, suggests that other revisions should be considered that may produce greater compliance with the EU’s macrobudgetary rules in times of future economic difficulty.

Numerous proposals for either terminating the SGP altogether or reforming it have emerged since 2003 (Collignon, 2004; Crowley, 2002; Enderlein, 2004; Hodson, 2004). Eliminating the SGP is obviously one solution to the problem of member state noncompliance. Indeed, the elimination of the SGP would still leave the excessive deficit procedure intact in the TEU’s Article 104. Thus, full elimination would also imply changing the Treaty text on the EDP or in any case a radically different approach to obtain the end result. Yet, if the EU remains committed to the goal of fiscal sustainability and the need for some type of restrictive macrobudgetary architecture, the debate over what the SGP should look like continues. Though the summaries of the following recommendations shown in Table 1 certainly do not constitute an exhaustive list of proposed revisions, they are indicative of the types of suggestions that are commonly offered to reform the SGP. In addition to terminating the SGP, these recommendations generally fall into five categories. They range from proposals that, first, emphasize greater flexibility by way of the application of ‘soft’ rather than ‘hard’ rules; second, that promote enhanced versions of the use of hard rules; third, that rely upon the ‘open’ coordination supplied by the member states themselves; fourth, that turn to powerful, autonomous, centralizing regulators and veto players at both the EU and member state levels, which under some conditions take the SGP’s decision making process out of the hands of ECOFIN and the member states altogether (Collignon, 2004; Hodson, 2004); fifth,
Table 1 Proposed reforms to the Stability and Growth Pact

*Terminate the SGP, Emphasize the EU Member States in Fiscal Policy Coordination, Rely on Soft Rather than Hard Fiscal Coordination: Abolish the SGP, and emphasize the member states’ role in coordinating their fiscal policies. The hard deficit and debt targets and explicit enforcement sanctions failed, financial penalties are too confrontational, and the SGP is too politically intrusive in member state fiscal policy decisions. Rely on the soft fiscal coordination present in the creation of the Broad Economic Policy Guidelines (BEPG) and the surveillance process provided for in the Maastricht Treaty’s Article 99, rather than the excessive deficit procedure of Article 104 (Enderlein, 2004).

*Soft Rather than Hard Fiscal Coordination with Revised Sanctions: The SGP’s hard deficit and debt targets and explicit enforcement sanctions have failed, financial penalties are too confrontational, and the SGP is too politically intrusive in member state fiscal policy decisions. Encourage member state learning and experimentation by relying upon the creation of individual fiscal sustainability plans that are developed through negotiation with the Commission. Create new economic metrics to determine compliance. Rely upon reputational sanctions and the potential loss of rights at the EU level, such as voting on issues related to the euro area (Schelkle, 2004, 2005; Begg and Schelkle, 2004).

*Reform without Hard Penalties: Focus on debt to GDP ratios rather than deficits to GDP, taking into account the need for public investment. Concentrate on cyclically adjusted budgets, and permit deficits exceeding 3 percent of GDP for cyclical reasons. Strengthen the Commission’s role in the surveillance procedure. Renounce the use of financial penalties in favor of reputational sanctions and peer pressure (Walton, 2004).

*Redirect SGP Incentives to Encourage Good Behavior in Good Times: The SGP fails to restrain fiscal policies when member state economies are growing, and imposes financial penalties on member states when their economies are weak. SGP should take into account the nature and composition of discretionary fiscal policy (Mayes and Viren, 2004).

*Keep the SGP As Is, but Strengthen Domestic Budgetary Institutions: Strengthen the domestic institutions of the member states, particularly their ministries of finance, throughout their budgetary processes, and encourage coalition governments to create domestic ‘fiscal contracts’ to reinforce their compliance with the SGP (Hallerberg, 2004b).

*Reinforce the Commission as SGP Enforcer: Strengthen the Commission’s role as the SGP’s ‘supreme enforcer’, while moving to a system of political rather than financial penalties for noncompliance. Political penalties could include requiring finance ministers to justify their policies before their own parliaments if the Commission issued an excessive deficit warning or recommendation against a member state. More resources would be devoted to developing the Commission’s cyclically adjusted analyses (Ubide, 2004).

*Create Independent Sustainability Council: The SGP’s deficit and debt targets are ‘dead rules’ due to their inflexibility, the goal shifted from sustainability towards ‘optimal’ fiscal policies, and it is increasingly difficult to enforce. A newly created independent Sustainability Council reporting to the European Parliament, would be charged with ensuring the sustainability EMU member state finances. The Council would assess the fiscal condition of the member state finances.
states, particularly the size of their public debt, and provide a flexible alternative to the dead rules. The member states would have to submit fiscal plans to the Council, which would have the authority to veto these plans. The Council would rely upon reputational and political sanctions derived from public support for the Council’s rulings, rather than financial sanctions on the member states (Fatas et al., 2003).

*Move to Further ‘Political Integration’ or ‘Ever Closer Union’: Following the logic of the earlier Werner Plan and the Delors Report, a step towards further economic integration would be necessary. A supranational authority would need to be set-up to deal with budgetary and fiscal matters to find the appropriate policy mix between ‘economic’ and ‘monetary’ policies. The ‘economic’ policies in this context would be budgetary policies (budgetary deficits and public debt) as well as further integration on fiscal policies (perhaps harmonization of corporate taxation). Advocates argue that it has been this asymmetry between transferring sovereignty from national to the supranational (EU) level in the one area (monetary policy) whereas a lack of transferring such sovereignty over economic policy (budgetary and some degree of fiscal policy) that makes EMU potentially unstable (Verdun, 1996, 1998; Padoa-Schioppa, 2004; Hodson, 2006).

Despite the variation in these proposals, what characterizes nearly all of them is their continued reliance on the SGP’s deficit and debt targets. The continued reliance on deficit targets both in ECOFIN’s revised SGP and in these proposed reforms, we argue, is reason why the member states so often fail to comply with the EU’s macrobudgetary rules. What the current SGP and these recommendations neglect to provide for in the architecture of their rules is the need to allow for politically achievable budgetary goals. If national political leaders are expected to make the difficult decisions that are required to comply with the SGP, they must be rewarded for their efforts. Realistic opportunities and positive incentives must, in other words, be created for national politicians to able to claim credit for their actions. As demonstrated by the American case presented here, macrobudgetary rules that rely upon deficit criteria produce budgetary targets that are often beyond the control of political actors. Thus, despite their efforts at fiscal restraint, which usually require a significant expenditure of political capital, political leaders receive at best limited political credit, even as weak economies drive their budgets deeper into deficit. The SGP reforms outlined in Table 1 depend upon almost all stick and very little carrot as incentives for compliance; even references to ‘peer pressure’ and ‘reputational sanctions’ are employed much more as forms of punishment rather than as rewards for political action. Meanwhile, some recommendations propose the solution to SGP noncompliance rests with strengthening
domestic budgetary institutions, such as ministries of finance that have the power to reject the budget requests of spending ministries (Hallerberg, 2004a,b). Yet, even member states that have expended the political capital needed to create strong ‘delegation’ finance ministries, the strongest of which are those of France, Germany, Greece, and the United Kingdom, all recently incurred deficits in excess of that mandated by the SGP. Despite these reforms in domestic budgetary processes and institutions, each member state remained tied to SGP’s deficit and debt targets. What the American experience suggests is that a reform the EU may want to consider is revising its budgetary goals in a way that pays greater attention to political leadership needs for credit claiming, in order to enhance its efforts at fiscal sustainability and budgetary compliance.

This study first explores the American experience since 1985 with three similar macrobudgetary laws aimed at promoting fiscal stability: Gramm–Rudman–Hollings, a law that aimed at reducing deficits to balance the budget, and the Budget Enforcement Act of 1990 and the Balanced Budget Act of 1997, which both targeted levels of spending rather than the size of deficits. Though the mechanics of the Gramm–Rudman–Hollings’ law certainly differ from those of the SGP, this paper argues that as the measure of successful compliance they both suffer from the same design flaw, namely their focus on deficit spending. After several futile years of trying to control their deficits, the Americans learned from this design flaw by changing the goal from constraining deficits and balancing the budget, to controlling spending in their latter two macrobudgetary laws. Details of these laws are provided so that their institutional strengths and weaknesses might be better understood for comparison with the SGP. Our research then suggests how these most recent American laws would apply in the case of Germany in 2003. Finally, this study offers recommendations for how the SGP could be improved by borrowing from the American trial-and-error learning in the development of such macrobudgetary rules.

2. LEARNING FROM THE AMERICAN EXPERIENCE WITH MACROBUDGETARY RULES

There are several reasons why the EU may look to the United States (US) for useful examples in macrobudgetary practices. First, the American experiment with these macro rules for fiscal consolidation at the national level dates from 1985, several years earlier than the Maastricht Treaty and the SGP. American state governments, meanwhile, have employed balanced budget requirements since the 1840s (Savage, 1988). Because of this extensive history, much of the literature on the design of budgetary rules is derived from American experiences at all levels of government, and has been applied by scholars to a variety of political and economic systems (Milesi-Ferretti, 1997; Poterba and von Hagen, 1999; Strauch and
von Hagen, 2000). Second, although the US is a single-state case study, as compared to the supra- and multi-national EU, its presidential system, with competing centers of executive and legislative budgetary decision-making power resembles the diversity of power centers in the EU. Third, the US struggled with macrobudgetary noncompliance, just as the EU does with the SGP, but found ways to reform its rules to gain compliance and achieve fiscal sustainability. The lessons the Americans painfully learned from the development of their national macrobudgetary rules may indeed suggest different, and perhaps more effective reforms for the SGP than those identified in Table 1.

2.1. The American experience with macrobudgetary rules: Gramm–Rudman–Hollings

The United States adopted the Balanced Budget and Emergency Deficit Control Act of 1985, better known as Gramm–Rudman–Hollings (GRH), in order to balance the federal budget. The word ‘emergency’ in the law’s title can convey only a little of how the fear of large-scale deficit spending and the desire to balance the budget dominated American domestic politics in the 1980s. Peacetime deficits of $200 billion were simply unheard of in American history. In only a few short years, the deficit grew from $27.7 billion in 1979 to previously unknown triple digit levels. The authors of the legislation, senators Phil Gramm (Republican-Texas), Warren Rudman (Republican-New Hampshire), and Fritz Hollings (Democrat-South Carolina), declared that failure to bring the deficit under control stemmed from the partisan and institutional stalemate over the composition of fiscal policy, and only a dramatic change in the government’s regular budgetary process could create the institutional rules and political incentives to break that partisan deadlock.

The deep partisan distrust that existed accounts for the budgetary process created by GRH. The president and Congress, it was argued, could not be counted on to balance the budget or even achieve meaningful deficit

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<td>1985 Law</td>
<td>−172</td>
<td>−144</td>
<td>−108</td>
<td>−72</td>
<td>−36</td>
<td>0</td>
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<td>−136</td>
<td>−100</td>
<td>−64</td>
<td>−28</td>
<td>0</td>
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<td>Actual deficit</td>
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<td>−150</td>
<td>−155</td>
<td>−152</td>
<td>−221</td>
<td>−269</td>
<td>−290</td>
<td>−255</td>
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reduction. So, as shown in Table 2, diminishing, annual allowable maximum deficit amounts (MDA) were identified, with a balanced budget reached in the sixth year after the law’s enactment. The President’s Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) were charged with monitoring compliance with the law and developing a report on deficit and expenditure estimates, taking into account changes in the economy, to determine whether a gap occurred between the MDA and the actual deficit. Differences between the two estimates would be resolved by averaging the figures. Because of the distrust existing between the executive and legislative branches, the more independent General Accounting Office (GAO) would evaluate the joint OMB/CBO report, and then issue its own definitive report. The objectivity of GAO’s report was undermined by a Supreme Court decision that declared the GAO’s involvement violated the Constitution’s separation of powers, as GAO was an agent of the Congress conducting an executive branch function by activating the sequester process. In GAO’s place, a joint House–Senate congressional committee was established to review the OMB/CBO report. It would then submit a resolution for congressional approval and presidential signature, which then, if necessary, activated GRH’s sanctions (Havens, 1986). Under the new system, the president, not the GAO with its congressional connection, would initiate the sequester.

GRH’s sanction consisted of sequestering, the cutting of budgets in an across-the-board fashion in designated accounts. The size of the sequester depended upon the amount necessary to eliminate the gap between the OMB/CBO estimated deficit and that year’s MDA, if the difference between the two were at least $10 billion. Such a sequester was immediately imposed in 1986, when the $171.9 billion MDA was projected to be exceeded by an estimated $48.6 billion. To test the law, but not activate it fully during its first year, a sequester of $11.7 billion, or 4.3 percent of non-exempt spending was imposed in 1986. Added to this institutional sanction was the continued, though by that time proven ineffective, reputational and political sanction of incurring large deficits. The primary incentive for politicians to comply with GRH came from the threat to cut their most cherished programs through sequestration. Fear of the sequester served as the incentive for politicians to do whatever was necessary to balance the budget. Yet, here again, mistrust influenced the design of the law. Congressional Democrats distrusted the Republican White House and the OMB from applying the law evenly and fairly to all programs. So, an extensive set of rules were developed as part of GRH that specified which programs would be cut and to what extent. Half the budget reductions would come from defense, the other half from non-defense programs. Some programs were completely exempt from the sequester, including Social Security, interest payments on the national debt, and certain welfare programs, such as food stamps. Other entitlement programs were partially protected, with
reductions limited to a maximum of 1 or 2 percent, or to cuts made only in their inflation adjustments. Altogether, the law exempted nearly two-thirds of the budget from sequestration.

2.2. Criticism of Gramm–Rudman–Hollings

GRH was immediately subject to intense criticism. First, critics decried the democratic deficit inherent in the automatic provisions in the sequester procedure. Rather than make the difficult decisions required to balance the budget, politicians surrendered their responsibilities to across-the-board budget cuts. Second, politicians whose favored programs were exempt from the sequester would be less motivated to protect the remaining programs by making the necessary policy fiscal policy decisions to avoid sequestration. Third, the one-third of the budget’s unprotected programs would unfairly bear the burden of these sequesters. In this way, the law perversely created an incentive for some members of Congress actually to increase their level of spending for their favored programs, if these programs were among the 30–40 percent that was subject to sequestering. These programs would be hit with an across-the-board sequester, regardless of the size of their budgets. The best way to protect these programs, therefore, would be to increase their budgets to better weather the sequester, rather than take action to avoid the sequester altogether. Fourth, to avoid these sequesters completely, the president’s budget could exaggerate economic assumptions that would reduce the size of the budget deficit. These assumptions would then determine whether there would be a sequester. In fact, both the OMB and the Congress manipulated economic and deficit estimates throughout the budgetary process. In some years the Senate would use one set of assumptions and the House a different set, both with the intent of avoiding sequesters. In this way, the Supreme Court’s ruling against the use of an impartial GAO crippled GRH’s surveillance process. Fifth, the fear of sequester encouraged the government to employ various accounting devices to reduce the deficit, including shifting expenditures to future fiscal years, one-time selling of government assets, overestimating tax collection receipts, and shifting programs into exempted categories of spending. Sixth, and most telling, the government failed to meet each of the law’s annual deficit targets and balance the budget (US National Economic Commission, 1989; Rubin, 2003).

To remedy some of these problems, a second version of the law was passed in 1987, commonly called Gramm–Rudman–Hollings II (GRH II). The revised law ordered that only one set of economic assumptions could be used throughout the budgetary process, so that the estimates would not be revised more positively to show greater deficit reduction. The new law eliminated the receipts derived from asset sales from use in the deficit calculation, and it also strengthened GRH II in a parliamentary fashion,
by providing for a point of order procedure in the Senate. Members could call a point of order against the violation of budgetary rules that could be overridden only by a super 60-vote majority. So, for example, a senator could call a point of order against an appropriations bill that exceeded its spending limit, and the bill would be forced back to its subcommittee origin for reconsideration. Only if the point of order were overridden by 60 votes could it be approved by the Senate. The revision also weakened the law’s sanction by allowing the president to exempt almost all personnel accounts from sequestration and by including certain inflation adjustments in the deficit calculation. Finally, the most significant change was the raising of the annual deficit targets and the extension of the balanced budget goal by two years (US Senate Budget Committee, 1987).

2.3. Lessons learned from Gramm–Rudman–Hollings

GRH is often regarded as a failure. Annual deficit targets were regularly exceeded and the budget never was balanced. The gap between the MDA and the actual deficits would have triggered draconian sequesters that would have devastated non-exempt programs. The gap of $121 billion for 1990, for example, would have imposed sequesters equal to 20–30 percent of those programs’ budgets. What this observation neglects, however, is that politicians enacted real reductions in spending and increased revenues because of the law, particularly in 1987. The initial 1986 GRH sequester, for example, produced some $28 billion in savings over two years, while the budget agreement of 1987 called for an estimated $76 billion in savings over two years. One well-regarded study of GRH’s influence indicates that the law restrained spending by $59 billion by 1989 in nonexempt programs (Hahm et al., 1992). The law proved to be weakest in constraining spending in the exempt categories, which included the politically sensitive entitlement programs. Consequently, if deficits were to be reduced and the budget eventually balanced, these programs needed to be subjected to some form of effective procedural control.

The GRH experiment in macробudgeting left the nation’s political leadership frustrated politically and personally by their inability to fulfill the law’s expectations. Despite imposing budget cuts on politically favored programs and raising some politically unpopular revenues, not only was the budget not balanced, the annual deficit targets proved to be increasingly elusive. The law essentially punished lawmakers each year leading up to the one in which the budget would be balanced. As that goal over time became less likely to be realized, member of Congress became increasingly creative in their ways of evading the law’s sanctions. The most important lesson learned from the GRH experiment was that the law held the Congress politically responsible for the deficit regardless of its budgetary policies, and regardless of what drove the deficit, the condition of
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the nation’s macroeconomy. The law simply neglected to take into account
the need to provide politicians with politically achievable, realistic, and
rewarding goals.

The Gramm–Rudman–Hollings law was unprecedented in the history of
American budgeting. The law not only specified deficit reduction targets,
it created a procedure that automatically cut the budget to reach these
targets if elected officials failed to reach them. The need for some automatic
process reflected the stalemate present in American politics that stymied
efforts to achieve an accepted national goal. Though widely criticized, the
law proved to be the first, and perhaps necessarily painful, stage in the
development of American macrobudgetary rules that eventually helped
the government balance the national budget.

3. THE AMERICAN EXPERIENCE WITH
MACROBUDGETING: THE BUDGET ENFORCEMENT
ACT OF 1990 AND THE BALANCED BUDGET
ACT OF 1997

Much had been learned about the incentive structures of budgetary proce-
dures during the four years the government operated under GRH. Above
all, the Congress wanted to be held responsible for activities under its di-
rect control, namely the size of federal spending, not the size of the budget
deficit, which varied according to changes in the macroeconomy. Political
leaders sought to limit sequesters to the programs that caused them, rather
than punish those that were relatively innocent. They also recognized that
reducing the size of deficits and federal spending depended upon creating
some process to control mandatory entitlement growth. Finally, Congress
sought to defeat some of the more egregious loopholes identified in GRH.
President George H.W. Bush and the Congress, by large, bipartisan mar-
gins, then responded to GRH’s failure by adopting the Budget Enforcement
Act of 1990 (BEA).

The most important difference between GRH and BEA was that balanc-
ing the budget no longer remained the government’s explicit policy goal.
Where GRH required annual deficit reductions leading to a balanced bud-
get, the BEA focused on controlling spending and avoiding breaching pre-
determined spending limits. So, where GRH required some combination
of spending cuts and tax increases to reduce the annual MDA to balance
the budget in six years, BEA essentially froze spending or allowed limited
annual increases for five years. The BEA’s budgetary success would be
determined by whether spending was held within ‘discretionary spend-
ing limits’. This meant that caps were placed on the total spending level
of discretionary, non-mandatory programs. As shown in Table 3, discre-
tionary spending was divided into three categories: defense, international,
and domestic. Each category was capped in terms of budget authority and

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Table 3  Budget Enforcement Act of 1990: Discretionary spending limits (billions of dollars)

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<td>Defense</td>
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<td>288.918</td>
<td>291.643</td>
<td>291.785</td>
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<tr>
<td>Outlays</td>
<td>297.660</td>
<td>295.744</td>
<td>292.686</td>
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<td>International</td>
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<td>Budget authority</td>
<td>20.100</td>
<td>20.500</td>
<td>21.400</td>
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<tr>
<td>Outlays</td>
<td>18.600</td>
<td>19.100</td>
<td>19.600</td>
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<td>Domestic</td>
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<td>Budget authority</td>
<td>182.700</td>
<td>191.300</td>
<td>198.300</td>
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<tr>
<td>Outlays</td>
<td>198.100</td>
<td>210.100</td>
<td>221.700</td>
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<td>Combined categories</td>
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<tr>
<td>Budget authority</td>
<td>510.800</td>
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<tr>
<td>Outlays</td>
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Outlays for three fiscal years, FY1991–93. Total levels of spending were set for FY1994 and FY1995, with the division of these totals into categories to take place during the consideration of the FY1993 budget. The caps could be adjusted to take into account inflation, changes in accounting rules, and emergency spending. The economic estimates used for the budget cycle would be locked into place when the president submitted his budget to Congress, thereby avoiding politically motivated optimistic revisions in the economic forecast.

To address the issue of controlling mandatory spending, the new law initiated the use of a pay-as-you-go (PAYGO) process. The PAYGO provisions required that all new tax as well as new mandatory legislation had to be deficit-neutral. This requirement applied to the net of all such legislation, not to individual bills. So, for example, the net legislative proposals that would increase entitlement benefits had to be offset by revenue increases that made the legislation deficit-neutral. By creating this tradeoff, PAYGO was designed to encourage compromise and bargaining in the setting of fiscal priorities (Frankel, 2005). PAYGO, it should be made clear, did not apply to the entitlement benefits and the resulting spending that stemmed from existing mandatory programs.

To enforce the spending caps and the PAYGO rules, the new law retained sequestration as the primary form of sanction for budgetary noncompliance. Sequestration in the BEA for discretionary spending differed from GRH in two important ways. First, there were far fewer exempt discretionary programs, the most noticeable exclusion being military personnel. Among entitlement programs, Social Security, most prominently, was
declared exempt. Second, only the categories of spending that exceeded the spending caps would be subject to sequestration. If the defense category exceeds its cap, only that category would undergo sequestration sufficient to comply with the cap, with that amount determined by OMB. Both OMB and CBO would produce sequestration reports, and GAO would produce a sequestration compliance report. ‘Firewalls’ were erected between the spending categories, so defense funding, for example, could not be transferred into the international category. Sequesters would be imposed if either budget authority or outlay targets were breached. If both forms of spending caps were exceeded, the sequester on budget authority would be calculated first, because changes in budget authority most accurately reflected changes in public policy. Sequesters could occur at various points at time in the budget cycle, depending upon type of appropriations bill and its enacting date, including a ‘look back’ procedure if a spending cap or PAYGO violation took place during a fiscal year. Furthermore, determining whether spending exceeded these caps proved to be a simpler procedure than making the more complex economic analysis of whether the GRH deficit levels were exceeded. Levels of spending could be calculated by examining the historical rate of outlays by account, whereas estimating deficit levels depended upon a broader analysis of the macroeconomy. Finally, an additional form of sanction came by way of parliamentary points of order made by individual legislators that were enhanced over their GRH versions. For example, rather than single-year points of order, legislation could be subjected to a five-year points of order if the item in question violated the forthcoming year’s spending levels, the sum of five year spending levels in a budget resolution, or if it violated the spending allocations made to the House and Senate Appropriations subcommittees (Rubin, 2003).

The BEA framework was extended throughout the 1990s, most notably in the Balanced Budget Act of 1997 (BBA). The Act stemmed from a broad budgetary agreement that reasserted the goal of balancing the federal budget. The BBA’s spending and revenue provisions reflected the political balance that had shifted from 1990. Whereas the president in 1990 was George H.W. Bush, a Republican who faced a Democratically controlled Congress, in 1997 the president, Bill Clinton, faced a Republican controlled Congress. Not surprisingly, under the American Constitution which locates the locus of budgetary decision making with the legislative branch, the budgetary priorities largely reflected the relatively unified Republican Congress. Under the BBA, total spending would decline by $961 billion over ten years, and revenues would be cut by $250 billion over the same period. Spending priorities would also change from the 1990 BEA. Comparing Table 3, which outlines the spending levels of the BEA, with Table 4, which does the same for the BBA, it may be seen that the 1997 law provided for a greater increase in budget authority for defense than the BEA, 7.8 percent over five years, versus less than one percent over three years. The 1997 BBA collapsed the
Table 4 Balanced Budget Act of 1997 (billions of dollars)

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defense</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budget authority</td>
<td>269</td>
<td>272</td>
<td>275</td>
<td>282</td>
<td>290</td>
</tr>
<tr>
<td>Outlays</td>
<td>267</td>
<td>267</td>
<td>269</td>
<td>271</td>
<td>273</td>
</tr>
<tr>
<td>Nondefense</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budget authority</td>
<td>258</td>
<td>261</td>
<td>262</td>
<td>260</td>
<td>261</td>
</tr>
<tr>
<td>Outlays</td>
<td>286</td>
<td>293</td>
<td>295</td>
<td>294</td>
<td>288</td>
</tr>
<tr>
<td>Total entitlement spending</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medicare</td>
<td>221</td>
<td>233</td>
<td>253</td>
<td>261</td>
<td>280</td>
</tr>
<tr>
<td>Medicaid</td>
<td>105</td>
<td>112</td>
<td>120</td>
<td>129</td>
<td>138</td>
</tr>
<tr>
<td>Entitlements</td>
<td>564</td>
<td>597</td>
<td>625</td>
<td>662</td>
<td>673</td>
</tr>
</tbody>
</table>


discretionary domestic and international spending categories created by the BEA into a single nondefense category, and essentially froze spending for those programs at a 1.2 percent increase over a five-year period (US House Budget Committee, 1997). Under the BEA, however, domestic spending was permitted to grow by 5.8 percent over three years. Though these changes in the content of spending were of political relevance for the politics of the day, the important consideration here is that both political parties supported the BEA’s macrobudgetary architecture.

3.1. Evaluating the effectiveness of BEA/BBA

How well did the federal government comply with the BEA/BBA spending caps, which constituted the core element of these laws? The relevant years for evaluating compliance with the laws are FY1991 through FY1998. By FY1999, with the budget balanced and the size of projected surpluses continuing to rise, the government de facto ignored the BBA and then formally suspended it in 2001. Table 5 provides data on the laws’ annual spending limits and the amount of spending that either was above or below the caps. The data indicate that from FY1991 through FY1994, budget authority for discretionary spending exceeded the caps by as much as $14 billion in 1992, but from FY1994 through FY1998 budget authority consistently fell below the spending level. Meanwhile, outlays exceeded the cap in several years, but by no more than $7 billion. Due to these spending violations, sequesters were twice imposed in the early FY1990s.

There are important caveats that should be considered when evaluating these laws. First, BEA/BBA only restrained new mandatory entitlement
## Table 5
Discretionary spending under the BEA/BBA: Variation between original spending caps and actual spending (billions of dollars)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Spending limits as enacted</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Budget authority</strong></td>
<td>492</td>
<td>503</td>
<td>511</td>
<td>511</td>
<td>518</td>
<td>519</td>
<td>528</td>
<td>531</td>
<td>533</td>
<td>537</td>
<td>542</td>
<td>553</td>
</tr>
<tr>
<td><strong>Outlays</strong></td>
<td>514</td>
<td>525</td>
<td>534</td>
<td>535</td>
<td>541</td>
<td>547</td>
<td>547</td>
<td>548</td>
<td>559</td>
<td>564</td>
<td>564</td>
<td>563</td>
</tr>
<tr>
<td><strong>Amount of spending that was above or below (−) the limits</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>Budget authority</strong></td>
<td>10</td>
<td>14</td>
<td>11</td>
<td>2</td>
<td>−16</td>
<td>−18</td>
<td>−17</td>
<td>−1</td>
<td>49</td>
<td>47</td>
<td>122</td>
<td>182</td>
</tr>
<tr>
<td><strong>Outlays</strong></td>
<td>−14</td>
<td>−6</td>
<td>5</td>
<td>7</td>
<td>−15</td>
<td>0</td>
<td>4</td>
<td>13</td>
<td>51</td>
<td>85</td>
<td>85</td>
<td>172</td>
</tr>
<tr>
<td><strong>Actual budget deficit (−) or surplus</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>−269</td>
<td>−290</td>
<td>−255</td>
<td>−203</td>
<td>−164</td>
<td>−107</td>
<td>−22</td>
<td>69</td>
<td>125</td>
<td>236</td>
<td>127</td>
<td>−158</td>
<td></td>
</tr>
</tbody>
</table>

*Source: US Congressional Budget Office (2003).*
spending through the PAYGO rules, they did not reform or contain the spending associated with existing programs. As a result, entitlement spending grew by approximately four to six percent during these years, even as discretionary spending was limited to some two percent growth at the same time. Second, the laws depended upon spending caps that were arbitrarily selected. Third, as in the case of GRH, the laws encouraged an annual, short-term focus in budgeting that did little to encourage thoughtful programmatic prioritization. This short-term thinking also encouraged the inevitable efforts at budgetary gimmickry. These included the shifting of programs from discretionary accounts to the mandatory category of spending, and the rise of emergency spending, which was exempt from the spending caps and sequestration.

Given the magnitude of total discretionary spending, BEA/BBA proved to be remarkably successful in limiting the growth of federal discretionary expenditures and the expansion of new unfunded mandatory programs. During the period FY1991 through FY1997, total regular discretionary budget authority fell $14 billion below the spending caps, and outlays fell $19 billion below the caps (US Congressional Budget Office, 2003). During these years of fiscal restraint, the budget deficit of $290 billion in FY1992 became a surplus of $69 billion in FY1998. Surpluses were then projected for at least the next ten years, with the real possibility that the entire national debt could be extinguished. As a result, the spending caps were ignored during next three years and the law was permitted to expire in 2002. Moreover, both George Bush and Al Gore proposed major tax cuts in 2000, with Bush’s enacted 2001 cuts reaching 1.4 percent of GDP. Recently, as the federal budget again is running huge deficits, many Republicans and Democrats have called for the reinstitutionalization of the BEA/BBA fiscal rules.

4. THE GERMAN CASE: APPLYING THE BEA/BBA TO THE EU

How would these American attempts at macrobudgetary rules work in the EU? To answer this question, it is useful to examine the case of Germany and the events that led to the crisis of 2003.

The fiscal and monetary regime in the EU’s euro area is characterized by supranational sovereignty over monetary policy provided by the European Central Bank, with fiscal policy determined by the sum of the policies of the national member state governments. To encourage some degree of fiscal coordination in the euro area, the TEU includes a macroeconomic and budgetary surveillance process and the excessive deficit procedure, which were later enhanced by enforcement provisions of the SGP. The SGP’s critics argue, however, that its sanctions are insufficient to prevent free-riding behavior by the member states. The SGP penalty system is
so draconian that it would only be applied after an extended period of blaming-and-shaming. The theme of our paper is on the benefits of an SGP that focuses on the level of government expenditures, rather than a government’s budget deficit as a percentage of GDP, as the measure of compliance with efforts at realizing euro area fiscal coordination.

As for the events that led to the crisis of 2003, recall that the Stability and Growth Pact consists of provisions that further strengthen and clarify the timetable and steps to take in the excessive deficit procedure (TEU Article 104). As a member state moves further along in the excessive deficit procedure, it comes closer to being penalized by paying a financial deposit or ultimately a fine for exceeding the deficit ceiling. In 2000, Germany recorded a budget surplus of 1.1 percent of GDP, with Finance Minister Hans Eichel predicting significant debt reduction, tax cuts, and spending increases. These plans were quickly set aside as Germany entered a recession in the third quarter of 2001, causing the government to estimate its deficit for that year at 2.5 percent of GDP. In August, Eichel raised the idea that the SGP be revised, with its focus placed on controlling spending targets rather than deficits, as deficits stemmed from changes in the macroeconomy rather than from policy decisions (Savage, 2005). ‘You can plan spending in a budget but you cannot plan your income’, Eichel noted. ‘The decisive thing for me is that we pursue [budget] consolidation steadfastly, independently of whether or not there is more or less income one year due to economic developments’ (Hulverscheidt and Dombey, 2001). After much outcry, Eichel recanted and declared, ‘We are firmly sticking to our goals of balancing the budget by 2006’ (Simonian, 2001).

As the recession deepened, Germany’s fiscal condition worsened. In January 2002, the Commission urged ECOFIN to issue Germany an early warning reprimand. Rather than embarrass the German government before the federal elections, due to be held in September of 2002, ECOFIN instead reached an ‘agreement’ with Germany that it would balance its budget in 2004. Nonetheless, the deficit continued to grow, and on 22 November 2002 the Commission initiated the first stage of the excessive deficit procedure (TEU Article 104 §3). ECOFIN agreed and in January of 2003 adopted the Commission’s recommendations, based on its cyclical econometric models, that Germany take corrective action to lower its deficit to 2.75 percent of GDP for 2003 (TEU Articles 104 §6 and §7). This Council recommendation required that Germany make fiscal policy changes amounting to one percent of GDP. The Germans, in compliance with the TEU and SGP’s surveillance procedure, reported that their 2002 deficit was 3.6 percent of GDP and that it would exceed 3.0 percent of GDP for 2003. In November 2003, the Commission notified ECOFIN that Germany’s deficit would remain excessive and recommended that further corrective action was necessary, equivalent to 0.8 percent GDP in 2004 and 0.5 percent of GDP in 2005.
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(Commission Recommendation for a Council decision TEU Article 104 §8 and Commission recommendation for Council decision TEU Article 104 §9). ECOFIN then shocked the Commission and the rest of the world by rejecting its findings and suspending the excessive deficit procedure against Germany (Council Conclusion of 25 November 2003). ECOFIN declared that the German government complied with its January recommendations to make budgetary changes equal to one percent of GDP, and that its excessive deficits stemmed not from the lack of political will or as a result of a rouge fiscal policy, but from a failing economy and a two percent fall in Germany’s GDP. ECOFIN rejected the Commission recommendation that a further 0.8 percent of GDP fiscal policy changes were required, and instead indicated that 0.6 percent was sufficient (Council Conclusion of 25 November 2003).

As the Council noted, Germany’s ability to comply with the Commission’s recommendation were greatly complicated by its domestic economic situation. In addition to a worsening macroeconomy, Chancellor Gerhard Schröder’s efforts to achieve budgetary savings through the reforms outlined in his ‘Agenda 2010 package’ required the support not only of his own Social-Democratic party, but also of the opposition Christian Democratic party and from the governments of the states (or Länder) who have competency over these policy areas. These politically difficult to enact reforms were a serious attempt at reforming the social welfare system and labor market in Germany. Thus, at a time when Schröder was engaged in highly sensitive coalition building, he confronted the Commission’s reprimand, and ultimately that of the Council, for failing to comply with the SGP. Seeing that France was facing its own reprimand in September 2003 (and that country had originally been willing to accept the next steps of sanction in the SGP), Germany sought an ally in France against the Commission. Joining then with France, the two member states successfully convinced the Council to suspend the excessive deficit procedures for both France and Germany (Heipertz and Verdun, 2003, 2005, 2006).

4.1. The German case: The value of spending targets rather than SGP deficit targets

If the SGP had relied upon spending targets, as found in the American macrobudgetary rules and called for by Hans Eichel, the EU’s crisis of 2003 and its aftermath could have been averted. If the targets had been met, particularly after the German government complied with ECOFIN’s January recommendations, Germany would have been in compliance with the SGP. The deficit, no doubt, would continue to grow, responding to both changes in Germany and Europe’s macroeconomic problems, and to Germany’s own automatic stabilizers. Yet, Germany’s public officials could
have justifiably claimed credit for complying with the SGP, and ECOFIN would not have appeared favoring the big member states. Germany, therefore, would have been behaving in a proper counter-cyclical fashion.

Finally, by determining whether Germany’s spending remained within its designated limits, the Commission would have spared itself from the criticism that its cyclical deficit calculations were flawed, if not biased. Spending levels can be evaluated by extrapolating from expenditure trends by budgetary accounts. The calculation of cyclically-adjusted deficit levels, as called for in the SGP, rests upon far more complex econometric models of the macroeconomy and fiscal policy. German authorities challenged the accuracy of the Commission’s cyclical forecasts, as one German economist noted, ‘The whole notion of structural deficit is very shaky. A lot of questionable assumptions go into these calculations’ (Savage, 2005: 177). The quality of the Commission’s cyclical models has been the subject of some debate in the EU (Fatas et al., 2003; Hodson and Maher, 2004). Without reliable models, the SGP’s reliance on deficit targets as the measure of proper budgetary policy is undermined. An SGP based on spending limits would free the EU of much of this discussion.

There are three reasons why such a revision in the SGP would be both practical and effective in the German case. First, as Hallerberg (2004a,b) suggests, Germany already possesses one of the four ‘delegation’ budgetary systems with strong ministries of finance in the EU, which has the power to reject the budget requests of spending ministries. Second, Germany’s strong Ministry of Finance and budgetary process is complemented by reforms that took place in 2004 that strengthen the fiscal link between the federal government and Germany’s 16 federal states (Benoit, 2004). These reforms include having the states share in any financial penalties imposed on the federal government because of SGP violations. European Commissioner Joaquin Almunia praised this new relationship in an October 2006 speech, saying ‘Some countries such as Austria, Belgium and Germany have adopted a cooperative approach that seeks to reach an agreement on the fiscal targets assigned to each level of government in order to ensure the respect of the SGP’ (Almunia, 2006). Third, as Hans Eichel suggested, Germany has already proved itself capable of controlling budgetary expenditures. Table 6 shows the level of general government expenditures for all types of spending for all levels of government, as well as the size of the budget deficit as a percent of GDP for the years 2000 through 2005. The table indicates that following a spurt of expenditure growth upon Germany’s entry into EMU, spending remained essentially steady-state in 2001 through 2003, and actually fell in 2004 and 2005 from 2003 levels as a percentage of GDP. If the SGP targeted expenditures rather than deficits, Germany would have been in compliance in 2003. Moreover, Germany’s political leadership received faint praise and little opportunity for political credit claiming for their efforts that kept spending...
Table 6 German general government budget expenditures and deficit, 2000–2005
(millions of 1999 DEM euros and as a percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditures as a percent of GDP</td>
<td>45.7</td>
<td>48.3</td>
<td>48.1</td>
<td>48.5</td>
<td>47.1</td>
<td>46.8</td>
</tr>
<tr>
<td>Deficit as a percent of GDP</td>
<td>+1.3</td>
<td>−2.8</td>
<td>−3.7</td>
<td>−4.0</td>
<td>−3.7</td>
<td>−3.2</td>
</tr>
</tbody>
</table>

*Estimate


under control. Instead, they experienced EU condemnation for growing deficits stemming from macroeconomic forces that overtook much of Europe.

5. CONCLUSION: RECOMMENDATIONS FOR REFORMING THE SGP

Having been part of an international change in government public finance reform, the EU might have produced a budgetary regime that member states could have more easily complied with had it not only reflected on its own path towards EMU, but also the experience of other countries seeking to achieve similar goals (i.e. reduce public debt and deficits). Failing that, the EU remains caught in its legal structure and thus stays within the paradigm of keeping budgetary deficits at three percent of GDP. As long as the EU retains the SGP, it is imperative that the law be made politically credible and effective in restraining member state budgets. Having one of its most publicly visible laws openly and repeatedly violated undermines the reputation, integrity, and political cohesion of the EU and the euro area. How, then, might the SGP reverse the member states’ difficulty with achieving compliance? To answer this question, the EU may benefit from the lessons the United States has learned from its experience with macrobudgetary rules.

First, the design of such rules must take into account the need for politicians to be able to claim credit for successfully compliant fiscal action. The Americans revised their macrobudgetary rules to accommodate this political requirement. The framers of the Maastricht Treaty were, in fact, also sensitive to this matter when they selected the Treaty’s fiscal convergence criteria. In 1992, high levels of compliance were expected for both the deficit and debt reference values, as the deficit criterion seemed within easy reach of most of the member states. By early 1997, however, a weak economy drove up the deficits of many of the EU’s governments, regardless
of their efforts to meet the convergence criteria. Without a burst of revenue producing GDP growth in the fourth quarter of 1997 (and some favorable budgetary accounting rulings by the Commission) Germany, France, Spain, and Italy would have incurred deficits in excess of 3 percent of GDP. Including economically dependent deficit reference values in the Treaty almost led widespread noncompliance with the Treaty’s convergence criteria and the collapse of the Economic and Monetary Union (Dyson and Featherstone, 1999; Savage, 2005). The crafting of SGP focused more on accommodating the immediate concerns of the Germans, rather than addressing the strategic need of all politicians to be able to claim credit for successful political action (Heipertz and Verdun, 2004). Hence, there was very little learning about the political difficulties of relying upon deficit targets incorporated into the design of the SGP.

Second, substitute spending targets for deficit targets. Macroeconomically driven deficit targets are often impossible to meet and, history shows, politically unrewarding. This will be the situation in the EU when the current euro area economic expansion inevitably begins to contract, and with it an increase in SGP noncompliance (International Herald Tribune, 2006). Even member states with strong domestic institutions, those that scholars describe as ‘delegation’ states because they possess powerful finance ministries that can control profligate spending ministries, will incur excessive deficits when their economies are weak (Hallerberg, 2004a), as has been the case in Germany, France, Greece, and the United Kingdom. As the International Monetary Fund (IMF) pointed out, the use of macrobudgetary rules that rely on spending limitations is already successfully at work in Europe, e.g. in Finland, the Netherlands, and Sweden. ‘This type of framework directly addresses distortions leading to excessive spending and does not automatically lead to a procyclical fiscal stance because stabilizers on the revenue side are free to operate. This type of rule can also curb the tendency to increase public spending during upturns. In addition, an expenditure rule can be easily explained to the general public and market participants, provided that the control aggregate is clear’ (Daban et al., 2003). Spending limits, consequently, would appeal to both small and large member states, because all would have greater control over their ability to comply with EU law than under the current SGP framework. Moreover, as the IMF noted, the member states would be encouraged to run proper countercyclical fiscal policies, rather than procyclical policies that chase after deficit reduction and balanced budgets in economically difficult times.

Third, employ spending targets rather than deficit targets to avoid dependency on unreliable econometric models. The shift from GRH to BEA/BBA pointed the way to a more credible and simpler estimate of budgetary aggregates that would activate the law’s sanctions for non-compliance behavior. Member states are now subjected to cyclical models of budgetary deficits that
are controversial, if not unreliable (Fatas et al., 2003; Hodson and Maher, 2004). As the German case indicates, because these models react to shifts in the macroeconomy throughout the fiscal year, the member states are at the mercy of ever-changing cyclical estimates of budgetary deficits. Fixed spending limits would enable the member states to better plan their fiscal policies, and they would be free from the constant uncertainty of cyclical modeling.

Fourth, create politically realistic and complyable fiscal sanctions. The American reform of its macrobudgetary rules shifted sanctions from draconian sequesters aimed at ‘innocent’ programs, to smaller, more politically acceptable and administratively manageable sequesters targeted at ‘guilty’ spending categories. A number of the recommendations shown in Table 1 suggest that the SGP’s hard financial sanctions be scrapped. The problem, however, is not that the SGP’s sanctions are financial or budgetary in nature, but that they are politically unrealistic. They require significant financial payments and impose significant political costs. Not surprisingly, ECOFIN has never punished a member state in this way as the SGP demands.

Fifth, create programmatic spending caps to set budgetary and policy priorities. These caps could be set, for example, in euros or perhaps in terms of percent of GDP. Setting the caps in terms of euros provides fixed spending targets throughout the fiscal year and thereby contributes to rational fiscal planning. A central point of this paper is that the initial American rule with its deficit reduction/balanced budget goal resembles that of the SGP, in that both rules aim at a moving target in the form of budget deficits, which are largely a function of changes in the macroeconomy that are often beyond the control of politicians. The Americans changed their rule to make it more effective by aiming at the more fixed target of spending levels than the moving deficit target of the SGP, and the EU may benefit by doing the same. So, using a GDP basis for setting caps has its own advantages, but spending levels may become less predictable with fluctuations in the economy and shifts in GDP. In the German case, for example, setting the cap at 47 percent of GDP for 2001 through 2005 would have allowed for an increase from 2000, but would have frozen spending during the next several years, while still allowing for higher spending rates than in 2004 and 2005. Obviously, these spending levels are open to negotiation. It is worth noting that the EU has recently developed the capacity to do so in a fashion similar to the BEA/BBA, by organizing spending by programmatic categories as well as by total levels of spending. This is a new development in international and national accounting rules and data collection, which permits the harmonization of budgetary figures by spending categories (OECD, 2004). The Maastricht Treaty required such harmonization of member state deficits by way of national accounting rules to determine their compliance with the convergence process (Savage, 2005). Using fundamentally the
same set of accounting rules, the Organisation for Economic Co-operation and Development (OECD) now has collected data on national budgetary expenditures by program. This means that spending caps by types of programs can help set budget priorities, perhaps in support of research and education programs as called for at the Lisbon Summit, in a more harmonized manner throughout the EU.

Sixth, create specific budgetary mechanisms to control entitlement programs and tax policy. PAYGO rules force politicians to make explicit tradeoffs that require offsets to accommodate additional spending for such programs or the lost revenue due to tax reductions. The EU may consider employing similar rules to complement caps on discretionary spending.

In conclusion, the EU needs to make further reforms to its macroeconomic framework (SGP and the Treaty) if it is to avoid the ongoing, politically corrosive effects of member state noncompliance. The model for these reforms may well be drawn from the painful lessons the Americans learned in creating their own macrorbudgetary rules.

NOTE

1 Budget authority is the total dollar value of obligations that an agency may incur that require immediate or future fiscal year expenditures. The actual expenditures for a given year are called outlays. Annual balanced budgets, deficits, and surpluses are determined by calculating the difference between revenues and outlays. To make changes in policy, lawmakers look first to changing levels of budget authority, which determines the size of outlays.

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