Should the European Stability and Growth Pact be Changed?

Against the background of several EU members' difficulties in meeting the terms of the European Stability and Growth Pact, calls for reform, or indeed abandonment, of the Pact have become louder. Is the Pact in its present form economically harmful? If so, how could the rules be changed to make more economic sense?

Peter Bofinger*

The Stability and Growth Pact Neglects the Policy Mix between Fiscal and Monetary Policy

The debate on the institutional design of European Monetary Union was characterised by a broad consensus among politicians and academics that "stringent rules" (Delors-Report) for national fiscal policies are a prerequisite for an efficient common monetary policy. This view shaped the Maastricht Treaty and it led to the Stability and Growth Pact (SGP). The current discussion on the SGP shows that the rules laid down in the SGP are assessed in a rather controversial way. The aim of this paper is a short evaluation of the SGP in the light of the experience of almost four years of EMU. It tries to find out whether the philosophy which underlies the SGP is supported by the facts and therefore whether policymakers in countries with high deficits should be advised to adhere to the SGP rules under all circumstances. This issue is of special importance in the context of the monetary dialogue with the European Central Bank, which is one of the most ardent supporters of a strict adherence to the SGP.[1]

It is well known that both the SGP and the criteria of convergence were not the result of an intensive academic debate. Especially the SGP can be clearly attributed to the situation in 1997 where additional safeguards were needed in order to mollify the strong fears of many Germans that EMU would lead to inflation. Accordingly the SGP is based on the philosophy that fiscal deficits are a main cause of inflation.

"The European Council underlines the importance of safeguarding sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. It is also necessary to ensure that national budgetary policies support stability oriented monetary policies."[2]

After almost four years of EMU it is possible to assess this core hypothesis. As Figure 1 shows, there is absolutely no evidence of a systematic correlation between the size of fiscal deficits and national inflation rates. If anything, the opposite seems to be true. This "anomaly" constitutes an important warning sign. If the underlying assumption of the SGP is flawed, it could be very dangerous to rely on its policy recommendations, especially in countries which are close to the 3 % threshold or even beyond.

The inherent problems of the SGP become obvious, if it is tried to solve the "puzzle" of high deficits and low inflation. A starting point is the more implicit assumption of the SGP that high deficits are caused by lax fiscal policies. A good test for this view is the correlation between the average real growth rate of government consumption and fiscal deficits during the EMU period. Again we are confronted with a somewhat surprising result (Figure 2). A low increase of real government consumption is on average associated with high deficits and vice versa. In other words, fiscal rectitude does not necessarily pay off.

Thus, another explanation for the differing deficit performance of the EMU member countries is required. An obvious candidate are the growth rates of real GDP. As Figure 3 shows, there is a relatively strong correlation between average GDP growth and average fiscal balances in the 1999-2002 period. In other words: the deficit problems with which several member countries are confronted today were mainly caused by below average economic growth during the four years of EMU.

* Professor of Monetary Policy and International Economics, University of Würzburg, Germany, and Research Fellow, CEPR, London, UK.

[1] E.g. in its October Bulletin (p.6) the ECB calls for "decisive action in order to set up credible adjustment paths" and it maintains "...adjustment paths must entail significant yearly improvements in the cyclically adjusted balance, to be followed strictly and completed within the shortest possible time frame."

[2] Resolution of the European Council on the Stability and Growth Pact, Amsterdam European Council, 16 and 17 June 1997.

Figure 1
Inflation Rates and General Government Fiscal Balances (1999-2002)

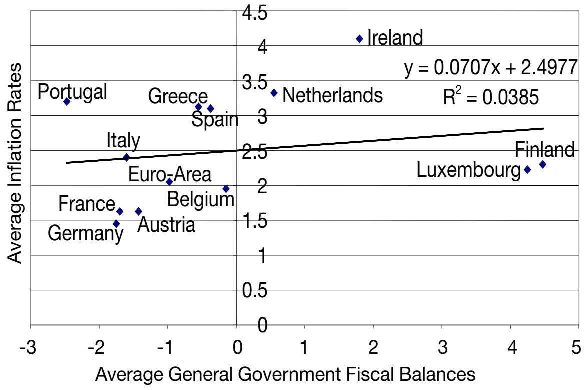


Figure 2
Real Government Consumption and General Government Fiscal Balances (1999-2002)

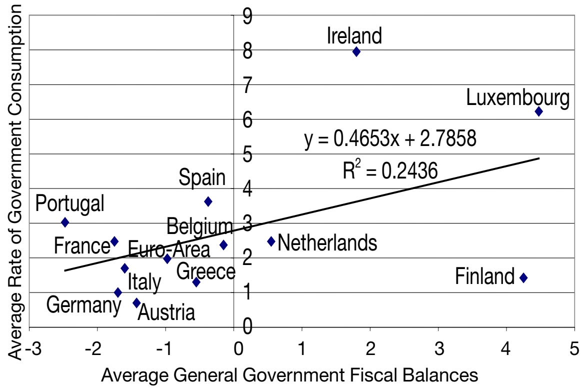


Figure 3
Real GDP Growth and General Government Fiscal Balances (1999-2002)

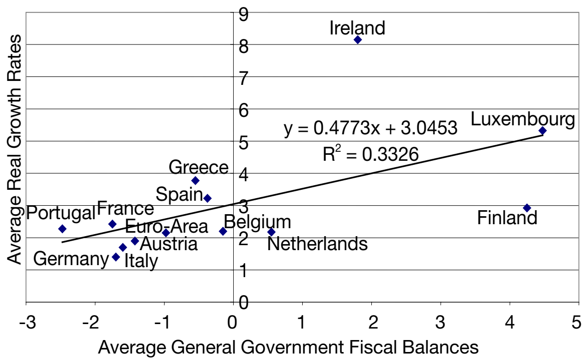
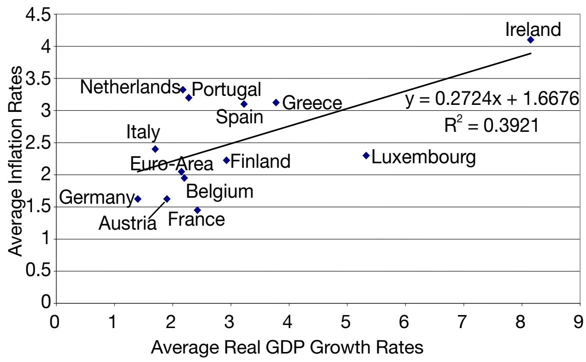


Figure 4
Real GDP Growth and Inflation Rates (1999-2002)



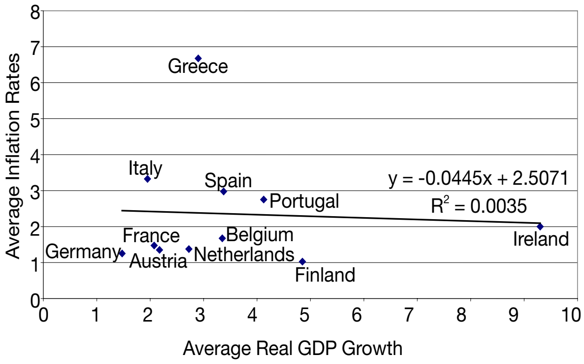
One could be tempted to argue that a low growth performance is not a cause but a consequence of high deficits and thus a too strong government interference with market processes. However, in Germany, where the GDP growth rate has been lowest of all EMU countries, the relationship of government expenditure to GDP (48.6 %) is almost identical with the EMU average of 48.5 %. At the other end of the spectrum, Finland with government expenditure equalling 50.4 % of GDP has been able to achieve an annual GDP growth rate of 2.9 %, which is higher than the EMU average of 2.2 %.

This leads to the question of other causes of the differences in real growth performance. Again a somewhat surprising finding can be presented. If average GDP growth and average inflation are plotted in a scatter diagram, a clear Phillips-curve relationship for the EMU period can be observed: a high national inflation rate goes hand in hand with high real growth (Figure 4).

This result can only partly be attributed to the Balassa-Samuelson effect, according to which countries with high productivity growth exhibit high inflation rates. This becomes obvious if we look at the same relationship in the four years preceding EMU. In the period 1995-1998 no evidence can be found for a Phillips-curve relationship although growth differentials were also considerable (Figure 5).

What is then a possible link between relatively high inflation rates and an above average growth performance? The answer is simple. In a monetary union the central bank can only set a common nominal interest rate for all member countries. The real interest rate, which is decisive for investors and the savings decisions of households, is determined at the national level according to the domestic inflation rate and inflation expectations. In other words the differences in national inflation rates in Figure 5 are identical with differences in national short-term real interest rates. Thus, whenever there are idiosyncratic factors leading to above or below average GDP growth, EMU is confronted with the risk of destabilising processes:

Figure 5
Real GDP Growth and Inflation Rates (1995-1998)



- In countries with a strong growth performance wage increases are relatively high. This leads to an above average inflation rate, and the real interest rate declines so that the economy obtains an additional stimulus. This process also improves the fiscal situation.
- In countries with a relatively weak growth performance, the increase in nominal wages and the inflation rate remain below the EMU average. As a result, the real interest rate is high and growth is additionally restricted. Due to low growth the fiscal position deteriorates over time.

A certain indication of a widening gap between high and low inflation countries is the fact that the inflation differential between EMU members has increased from 0.7 percentage points before EMU entry (1998) to 3.5 points in 2000 and it has remained at 3.2 in 2002.[3]

Thus, an adequate macroeconomic policy mix at the national level requires that national fiscal policy is flexible enough to provide the necessary compensation for overly restrictive or expansionary monetary policy conditions. Unfortunately, the founding fathers of the SGP were so occupied by the deficit-inflation nexus that they did not pay attention to this additional need for flexibility. Above all, they set the deficit threshold and the SGP escape clauses in too narrow a way, since they were derived from observations for the pre-EMU period, in which countries still had national monetary policy instruments (interest and exchange rate) at their disposal. While it is impossible in this short paper to define more adequate thresholds, one can at least say that it is dangerous if countries with "excessive deficits" and very low inflation rates are obliged to adhere to the SGP in a strict way. This calls for a procyclical fiscal policy stance so that fiscal policy – instead of compensating overly restrictive monetary conditions – could aggravate an existing imbalance by further reducing the national inflation rate.

Since fiscal policy rules are essential for the functioning of a monetary union, the analysis of this paper calls for a reform of the SGP. While the current framework with its focus on inflation is clearly too one-dimensional, it could be supplemented relatively easily with an additional dimension which takes care of the mix between the common monetary policy and national fiscal policies. Again, this paper can only give some general suggestions. Since the ECB has a very strong interest in preventing excessive inflation at the national level, it would be useful to base the assessment of fiscal policy on forecasts for the national rate and their compatibility with the ECB's inflation target.

- As long as the majority of forecasts show that a country's inflation rate will remain *within* the ECB's target range of "below 2%", it would be presumed that the overall policy mix of national fiscal policy and the national real interest rate was adequate. In this situation, a fiscal deficit exceeding the 3% threshold would not pose a problem for the common monetary policy. Of course, it would be necessary to make an additional assessment as to whether this fiscal policy stance could threaten the overall solidity of a country's public finances. For example, in the present situation in Germany such a risk could clearly be excluded.
- If the majority of forecasts show an inflation rate that exceeds the ECB's target range by a certain margin (e.g. one percentage point), it must be presumed that the policy mix is inadequate. If in this situation the deficit exceeds 3%, there is a strong indication that the national fiscal policy is not compatible with an adequate policy mix and an excessive deficit procedure would be warranted.
- If the forecasts show that the national rate will exceed the ECB's inflation target by a wider margin (e.g. two percentage points), imposing sanctions for fiscal policy could be considered even if the deficit is below three per cent or even if it is in a much better position.

The main advantage of this inflation targeting framework, which would of course need much discussion in detail, is that it provides the flexibility that national fiscal policy needs in a monetary union in order to cope with idiosyncratic shocks. At the same time, it would set more stringent fiscal limits for high inflation countries than envisaged in the SGP.

In sum, the main flaw of the SGP is its neglect of the interplay of national fiscal policy *and* national

[3] It is important to note that the widening was not caused by a "traditional" inflation country like Italy but by the high growth countries like Ireland which had rather low inflation rates before EMU entry.

monetary conditions in a monetary union. Although, as the example of Portugal shows, an "excessive deficit" can be caused by fiscal laxness, it can also be due to a self-aggravating process of below average growth, subdued nominal wage increases, below average inflation and an above average real interest rate. Thus, the SGP's one-dimensional focus on the deficit-inflation nexus can be totally misleading. A strict application of the SGP can have the consequence that a country is forced to abandon its only macroeconomic stabiliser and even to pursue a procyclical fiscal policy. The current attempt of the German government to reduce the structural deficit in a period of economic stagnation and increasing unemployment is a case in point. Together with above average real interest rates such a policy mix entails a high risk of deflation[4] and of a further widening of monetary conditions within EMU. As monetary policy would become very difficult under such conditions, the ECB should also have a strong interest in avoiding such risks.

Since fiscal policy rules are necessary in a monetary union, the SGP should be supplemented so that it sanctions fiscal policies only if a country's overall macroeconomic policy stance is inflationary, i.e. if forecasts show that its inflation rate will exceed the ECB's target rate by one or more percentage points. Such an "inflation targeting" approach would not only provide a better policy mix in countries with weak growth, since the 3% threshold would not be binding, but it would also improve the policy mix in above inflation countries since one could think of sanctions whenever the fiscal policy stance contributes to inflation beyond the ECB's target range.

[4] The editorial in the ECB's October Bulletin shows that the ECB is currently not fully aware of the risk with which some countries, especially Germany, are confronted. On page 6, the problem of a procyclical policy stance is downplayed as follows: "Credible fiscal consolidation is supportive to the outlook for economic growth. Direct effects on demand in the short term should be counteracted by higher credibility of the conduct of fiscal policy, boosting confidence and thus private spending."

Barry Eichengreen*

What To Do with the Stability Pact

Four years after the creation of the euro, the architects of Europe's single currency are entitled to bask in a warm glow of success. The transfer of power from national central banks to the ECB went off without a hitch. In its first four years the ECB has met its prime objective of maintaining price stability while pursuing a broadly appropriate monetary policy. The introduction of the physical euro went more smoothly than anticipated by even the most dyed-in-the-wool europhile.

The benefits of all this are undeniable. While the last few years have seen the collapse of equity valuations, a series of corporate scandals, terrorist attacks on a major financial center, mounting geopolitical tensions, and balance-sheet problems for a growing number of European banks, there has been no monetary turmoil like that which had been characteristic of European financial markets in the 1980s and 1990s. Western Europe has experienced no currency crises like those of its earlier history, which would have surely recurred in the absence of the euro. There has been no implosion of European financial markets – to the contrary, recent years have witnessed an unprecedented expansion of the securities-market access of the small, sub-investment grade companies that are the engines of growth in a modern, innovation-based economy. The last development – the growing depth and liquidity of Europe's corporate bond market – is similarly attributable to the euro.

Time to Rethink the Pact

Success breeds security, or at least it should. European policy makers should now feel secure enough to rethink their assumptions about the institutions of the euro area. Indeed, there are a number of signs that just such a rethink is already underway. The ECB Board has signaled a willingness to take a more flexible approach to the pursuit of its prime objective and to respond more quickly to changing macroeconomic conditions in the manner of the US Federal Reserve Board. It has indicated a readiness to accommodate the looming expansion of its membership by moving to a rotation system, in which all countries rotate on and off the policy-making council, something that would have been inconceivable as recently as three years ago. A rethink of the Stability and Growth Pact (SGP) should be next. Already the ECOFIN Council has revised its Code of Conduct on the content and presentation of the stability and convergence programs submitted in conjunction with the SGP, requiring the adoption of agreed assumptions regarding the main extra-EU variables and clarifying the meaning of the medium-term target of "close to balance or in sur-

*George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley, USA.

plus" by encouraging countries to make reference to cyclically adjusted budget balances and to provide an additional margin for fiscal responses to unforeseen budgetary risks.

But the SGP in fact requires a more fundamental rethink, starting with some serious thought about its ultimate objectives. The problem that the SGP is designed to address is not simply deficits larger than 3 per cent of GDP, for sometimes deficits in excess of 3 per cent are part of the solution rather than part of the problem, for example when the economy running them is in an exceptional recession. More fundamentally, the 3 per cent reference value is arbitrary. It has no basis in economic logic. It bears no obvious relationship to the sustainability of public debts, which is presumably the underlying concern that the pact is designed to address.

But neither is the 60 per cent reference value for public debts firmly related to this fundamental concern. While 60 per cent was in fact the EU-wide debt/GDP ratio in 1992, when the Maastricht Treaty was ratified, this is hardly a justification for enshrining this arbitrary number. Buiter, Corsetti and Pesenti[1] have noted that a deficit/GDP ratio of 3 per cent stabilizes a net debt/GDP ratio of 60 per cent when nominal income growth is 5 per cent, a fact that is sometimes invoked by defenders of the Pact. But the 3 per cent deficit/GDP ratio underlying this arithmetic has no basis in economic logic, as noted above. Historically, German public investment was 3 per cent of GDP, and there is an argument, the so-called "golden rule", that deficits which finance public investment do not create problems of sustainability. Today, however, public investment rates are all over the map: they range from about 1.5 per cent of GDP in Austria and Germany to some three times that level in Greece. If this is the rationale, then the reference value for deficits should be set at very different levels for different countries. In any case, income growth rates also differ across countries. This will be even more true in a European Union of 25 member states, which will include a cohort of Central and Eastern European countries whose real growth rates and inflation rates will both exceed the European average, reflecting their scope for catch-up growth and the operation of the Balassa-Samuelson effect.

The basic problem with the Stability Pact, then, is that it is based on arbitrary numerical rules that have little if any sound economic rationale and are therefore unlikely to be regarded as legitimate. Because those numerical rules bear only the loosest relationship to the ultimate objective of debt sustainability, they are not taken seriously. When there are disputes between the European Commission and national governments over a country's compliance, national officials are able to rebuff the disciplining efforts of the Commission by arguing that the reference values of the pact, even if appropriate for the average European country, are in fact quite irrelevant to their particular national circumstances. And, in some sense, this is exactly the problem. So long as the pact centers on arbitrary numerical thresholds, its relevance will always be limited, and governments will always be able to rebuff efforts to apply it. Europe's fiscal constitution, such as it is, will never be enforced.

Focus on Fiscal Procedures

Fortunately, there is another way. This is to focus on fiscal procedures rather than fiscal outcomes. The empirical literature shows that institutional arrangements are strongly and robustly associated with fiscal outcomes.[2] Countries with large vertical fiscal imbalances, where the central level of government raises the revenues but subcentral governments do the bulk of the spending, are prone to chronic deficits. States and municipalities are allowed to spend now and be bailed out by the central government later.[3] In contrast, where each fiscal jurisdiction has its own dedicated source of revenue, which is proportional to its spending obligations, problems of chronic deficits are less. Similarly, deficit bias is less in systems where national budgetary institutions are relatively centralized and hierarchical (where the president maintains a one-party majority in the parliament or where the number of veto players is small) than in those where spending authority is decentralized and the prime minister or finance minister has weak agenda-setting power.

The implication is that countries with well-designed and well-functioning fiscal institutions can be entrusted to run their own fiscal policies. Deficits today are not indicative of a chronic tendency to overspend and of a problem of debt sustainability; they just reflect the fact that revenues have fallen off, the economy is in a slowdown, and the country's automatic fiscal stabilizers have kicked in. On the other hand, in countries with poorly-designed and ill-functioning fiscal institutions, deficit bias is likely to be chronic, and this year's budget deficit should be seen as an early warning indicator of future problems.

[1] See Willem Buiter, Giancarlo Corsetti, Paolo Pesenti: Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht, in: Economic Policy, Vol. 8, No. 16, 1993, pp. 57-100.

[2] See Juergen von Hagen, Ian J. Harden: National Budget Processes and Fiscal Performance, in: European Economy, Reports and Studies, No. 3, 1994, pp. 311-418; Kichiro Fukasaku, Ricardo Hausmann (eds.): Democracy, Decentralization, and Deficits in Latin America, Paris 1998, OECD; Juergen von Hagen: Budgeting Institutions for Aggregate Fiscal Discipline, ZEI Policy Paper No. B98-01, Bonn 1998, Center for European Integration Studies.

Clear numerical limits on admissible deficit spending are needed to prevent such countries from accumulating unsustainable debts.

Hence, the Stability Pact should focus not merely on fiscal numbers, which are arbitrary and easily cooked, but also on fiscal institutions. The Council of Ministers should agree on an index of institutional reform with, say, a point each for public enterprise privatization, pension reform, unemployment and disability insurance reform, and revenue sharing reform. Countries receiving four points would be exempt from the Stability Pact's guidelines, since there is no reason to expect that they will be prone to chronic deficits. In contrast, the others, because their weak institutions make them susceptible to chronic deficits, would still be subject to the pact's warnings, sanctions, and fines.

Admittedly, altering the Stability Pact to focus on fiscal procedures rather than fiscal outcomes would not be without cost. The reference values of the current pact have the merit of simplicity (at the cost, as noted, of spurious precision). In principle, the answer to the question of whether or not countries are in compliance is relatively transparent. An institutional index determining whether or not they would be subject to non-interest-bearing deposits and fines would be more complex; hence the corresponding rating process would be more opaque. The question is whether this is a price worth paying.

In this connection, it is revealing to ask what kinds of governments rely on numerical rules to restrain the tendency to overspend and what kind of governments opt for procedural solutions to the problem of chronic deficits.[4] The governments of small countries tend to utilize numerical rules. Economic conditions within those countries tend to be relatively homogeneous, which means that a one-size-fits-all fiscal policy creates few problems. In addition, small governments tend to have limited administrative capacity; for them the simplicity of numerical rules has particular appeal. Larger countries, for both reasons, are more likely to rely on the procedural approach.

It is clear which of these ideal types the European Union resembles. The EU is a very large, relatively heterogeneous economy, for which the imposition of a single set of numerical guidelines for fiscal policy is likely to create significant inefficiencies. This fact manifests itself in the firestorm of complaints that has already arisen over the application of the Stability Pact. And, say what you will about the European Commission; one thing that it certainly is, is a big bureaucracy with reasonable administrative capacity.

Potential Objections

One can imagine various objections to this proposal for reorienting the Stability Pact from fiscal outcomes to fiscal institutions. There is the objection that an index of fiscal institutions would be less transparent, less easily monitored, and therefore less credible than a 3 per cent reference value for the consolidated budget deficit. In fact, this is not obviously correct. Economists have considerable experience in constructing simple quantitative measures of the relevant fiscal institutions, precisely in order to show that these are robustly correlated with observed fiscal outcomes. As already noted, there is a large empirical literature doing precisely this. And we should not overlook the ability of governments to fudge their fiscal accounts. Recall Italy's budget deficit in 1997, or the recent revisions of the Portuguese public accounts. My institutional indices may be disputable, but what about your deficit forecasts?

Then there is the observation that knowledge of what fiscal institutions help to avoid a bias toward excessive deficits may change over time, or that they may be context specific, rendering it a mistake to codify them. But permitting the politicians and officials responsible for the Stability Pact to alter the index of budgetary institutions would open the door to lobbying and backroom deal-making. This suggests creating an independent committee of fiscal policy experts to define the index. It may or may not be desirable for the members of that committee to also rate member states' compliance; I have an open mind on this question. It is important to emphasize that this would be a committee with much more limited powers than the one Ricardo Hausmann, Juergen von Hagen and I recommended for Latin American countries some years back, or that Charles Wyplosz and Simon Wren-Lewis have suggested in the European context.[5] Wyplosz and Wren-Lewis propose creating a committee with

[3] See Juergen von Hagen, Barry Eichengreen: Federalism, Fiscal Restraints and European Monetary Union, in: American Economic Review, Vol. 86, No. 2, 1996, pp. 134-138; Ernesto Stein: Fiscal Decentralization and Government Size in Latin America, in: Kichiro Fukasaku, Ricardo Hausmann (eds.): Democracy, Decentralization, and Deficits in Latin America, Paris 1998, OECD, pp. 95-120.

[4] See Juergen von Hagen: Budgeting Institutions for Aggregate Fiscal Discipline, ZEI Policy Paper No. B98-01, Bonn 1998, Center for European Integration Studies.

[5] See Barry Eichengreen, Ricardo Hausmann, Juergen von Hagen: Reforming Budgetary Institutions in Latin America: The Case for a National Fiscal Council, in: Open Economies Review; Vol. 10, No. 4, 1999, pp. 415-442; Simon Wren-Lewis: The Limits of Discretionary Fiscal Stabilisation Policy, in: Oxford Review of Economic Policy, Vol. 16, No. 4, 2000, pp. 92-105; Charles Wyplosz: The Stability Pact Meets its Fate, paper prepared for the Euro 50 Group, Paris, 27 November 2002; Charles Wyplosz: Fiscal Policy in EMU: Rules or Institutions?, paper prepared for the Group of Economic Analysis of the European Commission, April 2002.

the power to determine the deficit, presumably with cyclical conditions in mind, the idea being that governments in countries with very serious political distortions should delegate this decision. But European countries are not banana republics and do not, in my view, require such radical measures; their political distortions are not this severe. Under my proposal for reforming the Stability Pact, the power to decide the size of the deficit would still rest with national politicians and officials. The committee would only decide on the criteria determining whether or not a country was subject to the 3 per cent limit.

Finally, there is the objection that countries would not tolerate having a committee of the EU prescribe the structure of their fiscal and political institutions. But, in fact, the committee I envisage would not have the power to force a country to modify its institutions. If countries prefer institutional arrangements that have proven to be conducive to chronic deficits in other times and places, they would be free to do so. They would then be subject to the surveillance and reference values of the Stability Pact, but if they were able to keep their deficits below 3 per cent, contrary to the experience of other countries with similar institutions, they would not be subject to fines, non-interest-bearing deposits, or even warnings. And if they kept their budgets near balance or in surplus in normal times, there would be plenty of room for their automatic stabilizers to operate.

A Radical Proposal?

This proposal is in fact not unlike the procedures already followed by commercial rating agencies. The rating agencies give countries numerical ratings (or their alphabetic equivalent) on the basis of a combination of quantitative and qualitative inputs, using information about the structure and efficiency of their political and economic arrangements, among other considerations. In other words, the rating agencies already consider institutions. They have not found it impossible to systematically translate information about them into numerical indices, on whose basis commercial banks, pension funds and others make consequential economic decisions. Questions can and have been raised about the efficiency with which commercial ratings predict future economic problems, but the same can be said about the EU's current procedures, and in particular about the Stability Pact's crude numerical ceilings. It can be argued that the procedure I propose should be more information efficient, in the sense that it would take a broader range of economic, financial and institutional variables into account.

Replacing present procedures with an institutional index that determines which European countries are and are not subject to the warnings, non-interest-bearing deposits and fines of the Stability Pact might seem like a radical fix for a relatively minor problem. But it would be less radical than abolishing the pact. All that would change under the new approach is that different rules would be used for determining which countries are and are not to be subject to its excessive deficit procedure, the specifics of which would otherwise remain unchanged. These reforms would be less damaging to the credibility of the European Union than maintaining the pretense that the present pact will be applied objectively, to large and small countries alike, while regularly acceding to the objections of large countries, reflecting the reality that the existing pact lacks legitimacy and therefore credibility. Seen in this light, the reforms suggested here are not so radical after all.

Sylvester C.W. Eijffinger*

How Can the Stability and Growth Pact be Improved to Achieve both Stronger Discipline and Higher Flexibility?

The Stability and Growth Pact (SGP) is under fire. Problems have appeared in sticking to the rules. Proposals to reform the Pact or ditch it altogether abound. But is the Pact a flawed fiscal rule? Against established criteria for an ideal fiscal rule, its design and compliance mechanisms fare reasonably well. Where weaknesses are found, they tend to reflect trade-offs typical of supra-national arrangements. In the end, only a higher degree of fiscal integration would remove the inflexibility inherent in the recourse to predefined budgetary rules. This does not mean that the EU fiscal rules cannot be improved. However, given the existing degree of political integration in EMU, internal adjustment rather than attempting to redesign the rules from scratch appears a more suitable way to bring about progress. Redefining the medium-

* Professor of European Financial Economics and Jean Monnet Professor of European Financial and Monetary Integration, CentER, Tilburg University, The Netherlands; Research Fellow, CEPR, London, UK; Research Fellow, CESifo, Munich, Germany. He is also a member of the Panel of Experts of the Committee on Economic and Monetary Affairs of the European Parliament for which this article was written as a Briefing Paper (November 2002).

term budgetary target, improving transparency, tackling the pro-cyclical fiscal bias in good times, moving towards non-partisan application of the rules and improving transparency in the data can achieve both stronger discipline and higher flexibility.[1]

Critical Issues in the Implementation of the SGP

In the recent debate on the SGP, six main lines of criticisms have been put forward.[2]

Allegation 1: The SGP reduces budgetary flexibility. Under the Pact, the 3% of GDP reference value has become a hard ceiling to be breached and only in exceptional circumstances and for a limited period. As the literature on currency areas has shown, higher budgetary flexibility is required to respond to country-specific shocks in the absence of national monetary independence.[3] In order to create sufficient room for manoeuvre, a rapid transition to broadly balanced budgets in structural terms is required. In a situation of subdued growth, such transition would require pro-cyclical policies that may worsen the cyclical conditions. Pro-cyclical policies cannot be excluded in the future if the room for manoeuvre envisaged by the SGP turns out to be insufficient to cope with large-scale recessions and adverse shocks.

Allegation 2: The SGP works asymmetrically. The Pact does not curb governments' incentives to increase expenditure or cut revenue in favourable cyclical periods. There is nothing in the SGP preventing countries from undertaking pro-cyclical expenditure increases and tax reductions during periods of strong growth.[4] While headline budget figures may not deteriorate, the underlying budgetary position will, thereby leaving the countries exposed in the event of a slowdown in economic activity. Evidence of a pro-cyclical bias still affecting budgetary policies in euro area countries is provided by fiscal behaviours in the year 2000. In a situation of buoyant growth (3.4% for the euro area as a whole) and an oil price hike which put upward pressure on inflation, countries with high deficits failed to seize the opportunity to reduce their fiscal imbalances.[5]

Allegation 3: The SGP does not sanction politically motivated fiscal policies. Unlike the Maastricht convergence, sticking to the rules of the SGP may not pay politically. As argued by Buti and Giudice,[6] rewards for complying with Maastricht public finance requirements and penalties for failing to do so were very clearly laid out in the run up to EMU. Meeting the convergence criteria would allow budgetary laggards to join the virtuous countries in the new policy regime. Conversely, failure carried the penalty of exclusion from the euro area. Under the SGP, the carrot of entry has been eaten while the stick of exclusion has been replaced by the threat of uncertain and delayed sanctions. Moreover, the very success of the SGP in reducing the budget deficits would in fact rebuild the capacity of governments to pursue politically motivated fiscal actions. This temptation may prove irresistible in election years.[7]

Allegation 4: The SGP discourages public investment. Maintaining budget positions "close to balance or in surplus" implies that capital expenditure will have to be funded from current revenues. Hence, it will no longer be possible to spread the cost of an investment project over all the generations of taxpayers who benefit from it. This may imply a disincentive to undertake projects producing deferred benefits and entailing a significant gap between current revenues and current expenditures. The disincentive is stronger during consolidation periods.[8]

Allegation 5: The SGP disregards the aggregate fiscal stance. Under the Pact, each country is responsible for national fiscal policies. However, the aggregation of nationally determined fiscal policies may not result in an optimal fiscal stance at the euro area level. In turn, the aggregate fiscal stance may not be suitable to ensure an adequate policy mix. An inappropriate

[1] This article is a summary of an extensive study. See M. Buti, S. Eijffinger, D. Franco: Revisiting the Stability and Growth Pact: Grand Design or Internal Adjustment?, CEPR Discussion Paper No. 3692, 2002.

[2] Ibid.

[3] On the other hand, because of the common monetary policy, in the euro area monetary shocks should not take place anymore. See J. Frankel, A. Rose: The Endogeneity of the Optimum Currency Area Criteria, in: Economic Journal, Vol. 108, 1998, pp. 1009-25.

[4] M. Buti, B. Martinot: Open Issues in the Implementation of the Stability and Growth Pact, in: National Institute Economic Review, Vol. 174, 2000, pp. 92-104; S. Korkman: Fiscal Policy Coordination in EMU: Should it Go Beyond the SGP?, in: A. Brunila, M. Buti, D. Franco (eds.): The Stability and Growth Pact – The Architecture of Fiscal Policy in EMU, Basingstoke 2001, Palgrave, pp. 287-310.

[5] As shown in M. Buti, A. Sapir (eds.): Economic Policy in EMU, Oxford 1998, Oxford University Press, budgetary consolidation in Germany, France and Italy – three of the countries which did not meet the close-to-balance rule of the SGP – was considerably worse than the already timid efforts which were planned in their stability programmes. This contrasts sharply with the rest of the euro area members whose budgetary out-turn was better than planned.

[6] M. Buti, G. Giudice: Maastricht's Fiscal Rules at Ten: An Assessment, in: Journal of Common Market Studies, Vol. 40, No. 5, 2002, pp. 823-47.

[7] Buti shows that negative deviations from the targets in cyclically-adjusted terms set out in the Stability Programmes appear larger and more systematic in election years than in other years; see M. Buti: Public Finances in the Early Years of EMU: Adjusting to the New Policy Regime, paper prepared for a workshop of the Foundation for the Modernisation of Spain, October 2002. With a different approach, von Hagen finds that in the period 1998-2001 the expansionary stance in the year preceding the election had been twice as large as that in other years; see J. von Hagen: More Growth for Stability – Reflections on Fiscal Policy in Euroland, ZEI Policy Paper, June 2002.

fiscal stance may occur without formally violating the rules of the SGP. For instance, a shift from surplus to balance in several countries at the same time may lead to an over-expansionary fiscal stance while remaining within the boundary of the Pact. Conversely, the rule-based coordination envisaged by the Pact may not be adequate to respond to large common shocks, which would require a coordinated response.

Allegation 6: The SGP focuses on short-term commitments and disregards structural reforms. This criticism has different nuances. First, the SGP focuses almost exclusively on short-term objectives for the budget deficit. As such, it provides incentives for creative accounting and one-off measures, which blur the transparency of public accounts. Second, the stock of public debt does not enter the SGP and neither do the contingent liabilities of public pension systems. Hence, the Pact treats equally countries with different medium and long-term prospects and different debt levels. This may imply that the Pact is too demanding for countries in sound fiscal positions. Third, the Pact may prevent countries from implementing policies – such as pension reforms – which improve sustainability over the medium and long term at the price of a short term deficit worsening.[9]

According to the above allegations, the Pact is too uniform; it does not include incentive-compatible mechanisms; it does not encompass area-wide concerns and does not properly address the issues of economic growth and long-term sustainability.

Revisiting the SGP: A Proposal of Internal Adjustment

Our analysis of the SGP[10] against desirable rules standards for design and compliance shows that the current EU fiscal rules fare reasonably well, especially if account is taken of their multinational character. Nonetheless, improvements can be achieved. In our view, key aspects are allowing a certain country-specificity, re-balancing their sticks and carrots, and enhancing enforcement mechanisms. These improvements can be done within the current set of rules, via a code of conduct agreed between EMU players. Our proposal involves a diversification of the medium-term targets, higher transparency and better monitoring, mechanisms to correct misbehaviour in good times and a non-partisan application of the rules.[11] Table 1 summarizes the thrust of the proposal.

Table 1
The Buti-Eijffinger-Franco Proposal for Internal Adjustment of the SGP

GOAL	PROPOSAL	OPERATIONAL STEPS
Overcome excessive uniformity of the rules	- Diversify close-to-balance	- Common estimates of contingent liabilities - Common estimates of net investment.
Improve transparency	- Structural balance targets - Monitor cash figures	- Define one-off measures - Countries to explain divergence between cash and national accounts
Correct pro-cyclical bias	- Early warning in good times - Rainy-day funds	- Define maximum allowed worsening of cyclically adjusted balance - Interpretation ESA 95
Move to non-partisan enforcement	- Commission implements the rules, Council decides on policy measures	- Define relative tasks between Commission and Council

Source: M. Buti, S. Eijffinger, D. Franco: Revisiting the Stability and Growth Pact: Grand Design or Internal Adjustment?, CEPR Discussion Paper No. 3692, 2002.

Proposal 1: A country-by-country articulation of the medium-term budgetary target. The close-to-balance rule interpreted as broadly balanced budgets in cyclically adjusted terms may lead to excessive uniformity between countries. This interpretation treats equally countries with different levels of public debt, different contingent liabilities, and different public investment needs. So far, the only dimension along which countries are differentiated is the variability of the cyclical component of the budget balance: economies subject to higher business cycle volatility and having larger automatic stabilisers require a larger cyclical safety margin in order to avoid breaching the 3% of GDP

[8] The idea that investment is reduced more than other items during fiscal consolidations is largely shared in the literature; see H. Oxley, J.P. Martin: Controlling Government Spending and Deficits: Trends in the 80s and Prospects for the 90s, OECD Economic Studies, 17, 1991, pp. 145-189; and J. de Haan, J.E. Sturm, B.J. Sikken: Government Capital Formation: Explaining the Decline, in: Review of World Economics, Vol. 132, 1996, pp. 55-74. F. Balassone and D. Franco (Public Investment, the Stability Pact and the Golden Rule, in: Fiscal Studies, Vol. 21, No. 2, 2002, pp. 207-29) show how the introduction of a deficit ceiling can imply a reduction in investment in a two period model where a policymaker with a finite horizon maximises disposable income and the latter is positively affected by investment with a lag.

[9] For a theoretical model, see A. Razin, E. Sadka: The Stability and Growth Pact as an Impediment to Privatizing Social Security, CEPR Discussion Paper, No. 362, 2002. According to F. Ballabriga and C. Martinez-Mongay (Has EMU Shifted Policy?, European Commission, Economic Papers, No. 166, 2002) EMU has shifted fiscal policy to a shorter horizon compared with the pre-EMU period.

[10] See M. Buti, S. Eijffinger, D. Franco, op. cit.

[11] Our proposals are largely consistent with the new strategy of implementation of the SGP put forward by the Commission on 24 September 2002. In order to tackle effectively the imbalances of Germany, France, Italy and Portugal, the Commission restates the 3% of GDP as a "hard" ceiling for the deficit, suggests focusing on underlying balances when assessing compliance with the close-to-balance rule of the Pact, requires attaining an annual minimum structural adjustment of 0.5% of GDP for the countries still away from close-to-balance and asks for a commitment to accelerate the adjustment in times of boom.

[12] European Commission: Public Finances in EMU – 2002, European Economy, 3, 2002.

deficit ceiling under normal cyclical circumstances. The latest Commission estimates of the so-called "minimal benchmarks" indicate that the large euro area countries should have a cyclically adjusted deficit below 1.5% of GDP while most of the other countries should be below 1% of GDP.[12] The articulation of the medium-term budgetary targets could be extended to other dimensions, such as: (a) the financial fragility of the country embodied in stock of public debt; and (b) the threat to long-term sustainability given by the implicit liabilities of pension systems.

More specifically, countries with a relatively low stock of debt – i.e. well below the 60% of GDP reference value – and with relatively low estimated contingent liabilities could be allowed to have cyclically-adjusted budget deficits up to their minimal benchmarks. In practice, this implies a medium term deficit target for countries without sustainability concerns in the range of 1 to 1.5% of GDP.[13] This solution would be consistent, in most cases, with a prudent version of the golden rule. As pointed out above, in the case of public investment, the right concept is that of *net* investment (hence taking into account amortisation). In order to avoid moral hazard, commonly agreed estimates of contingent liabilities in EU countries would have to be computed, following the experience of the Economic Policy Committee's estimates of age-related public spending.[14] Countries would have to provide transparent projections on a regular basis.[15] The possibility to have a small structural deficit could be limited to the countries for which expenditure trends do not imply a debt level rising above the 60% threshold over a certain period of time.[16] Alternatively, a variety of sustainability indicators could be used: tax-gaps, government net worth, and generational accounting. Since each indicator requires some arbitrary choices, it would be necessary to predefine the relevant assumptions and parameters.[17] The debt ratio in high debt countries and in countries with expected rising expenditure levels would decline fast, thereby contributing to offsetting the burden of ageing in the future, while in the other countries deficit levels would ensure the maintenance of a small public debt. To ensure fiscal prudence, however, permanent and temporary flexibility should not be additive: in order to safeguard the 3% deficit ceiling, the medium-term target should not exceed the minimal benchmark.

Proposal 2: Improving transparency. An effort should be devoted to enhancing transparency in current and perspective fiscal accounts. In general, transparency can increase the credibility of rules by allowing a better judgement of fiscal performance and by limiting the role of accounting creativity in meeting targets.[18] This can allow greater flexibility in the implementation of rules.[19] In recent years, several countries have taken measures to improve fiscal reporting and ensure greater fiscal transparency.[20] The current EMU fiscal framework has been criticised for a certain lack of transparency. As spelled out above, this issue has different facets. First, in order to meet the short term targets, countries have frequently adopted one-off, cash-raising measures instead of making the necessary structural adjustment. Second, under the current system of national accounts, monitoring is hampered by delays in data provision with the implication that the whistle is often blown far too late. Again, especially in election periods, incumbents can exploit this lack of transparency. Third, data on off-budget liabilities and budgetary prospects have generally been rather lim-

[13] According to the European Commission estimates, these margins would be adequate for the larger countries. See also the estimates by Dalsgaard and de Serres (T. Dalsgaard, A. de Serres: Estimating Prudent Budgetary Margins, in: A. Brunila, M. Buti, D. Franco (eds.): The Stability and Growth Pact – The Architecture of Fiscal Policy in EMU, Basingstoke 2001, Palgrave, pp. 204-234), Barrell and Dury (R. Barrell, K. Dury: Will the SGP Ever Be Breached?, in: A. Brunila, M. Buti, D. Franco (eds.), op. cit., pp. 235-255) and Buti, Franco and Ongena (M. Buti, D. Franco, H. Ongena: Budgetary Policies During Recessions – Retrospective Application of the Stability and Growth Pact to the Post-War Period, in: Recherches Economiques de Louvain, Vol. 63, No. 4, 1997, pp. 321-66). The risk of breaching the 3% threshold would be further reduced by the introduction of rainy-day funds.

[14] Economic Policy Committee: Budgetary Challenges Posed by Ageing Populations: the Impact of Public Spending on Pensions, Health and Long-term Care for the Elderly and Possible Indicators of the Long-term Sustainability of Public Finances, 2001, EPC/ECFIN/655.

[15] It would also be useful to attribute the responsibility for projections to independent authorities or to competing institutions. See D. Franco, M.R. Marino: The Role of Forecasts in Social Security Policy, in: Giornale degli economisti, forthcoming.

[16] See the exercises in B. Delbecque, H. Bogaert: L'incidence de la dette publique et du viellissement démographique sur la conduite de la politique budgétaire: une étude théorique appliquée au cas de la Belgique, Bureau du Plan - Planning Papers, No. 70, November 1994; and D. Franco, T. Munzi: Ageing and Fiscal Policies in the European Union, in: European Economy, Reports and Studies, 4, 1997, pp. 239-388.

[17] See F. Balassone, D. Franco: Assessing Fiscal Sustainability: a Review of Methods with a View to EMU, in: Banca d'Italia: Structural Budget Balances, Rome 2000, pp. 22-60, and the other essays in this volume.

[18] IMF: Fiscal Policy and Macroeconomic Stability, May 2001.

[19] A. Kilpatrick: Transparent Frameworks, Fiscal Rules and Policy-Making Under Uncertainty, in: Banca d'Italia: Fiscal Rules, Rome 2001, pp. 171-216.

[20] J. Janssen: New Zealand's Fiscal Policy Framework: Experience and Evolution, in: Banca d'Italia: Fiscal Rules, Rome 2001, pp. 171-216.

[21] The measurement of one-off effects in public budgets raises some methodological problems. Public spending normally reflects several measures and events with temporary expansionary or restrictive effects. It may probably be useful to consider only the measures having transitory effects on public revenues (e.g. sales of assets, anticipation of tax payments, tax amnesties). Guidelines concerning the definition of one-off measures would have to be agreed in advance.

ited. To remedy the first problem, compliance with the EU rules should distinguish between long-lasting and one-off measures.[21] Given the current legislation and accounting conventions, the 3% rule cannot be modified to allay this concern. However, the size of one-off measures could be easily publicised. Moreover, in deciding whether or not to address an early warning to a deviant country, the existence of temporary measures should be ascertained. In practice, the danger threshold for the actual deficit should be lower in the event of a country relying on temporary measures. As to the medium-term target, in assessing compliance with the close-to-balance requirement, the structural balance should be computed, which implies correcting the cyclically adjusted balance for the budgetary effects of one-off measures.[22] In short, the experience of 2000-2001 with the UMTS proceeds should be extended to all temporary measures. In order to implement this, an agreed definition of one-off measures should complement the existing agreement on how to compute cyclically adjusted balances. The problem of early detection of deviations from targets was vividly exposed in the case of Portugal in 2001. Moreover, one can see that public debt growth has frequently exceeded the deficit level. Stock-flow effects have systematically contributed to debt growth. A way to tackle this issue is to resurrect, in parallel with national accounts definitions, regular monitoring of cash flows. National authorities would be required to indicate *ex ante* cash figures broadly consistent with the ESA95 balance. Alternatively, changes in the debt level (net of the effects of exchange rate changes and privatisation proceeds) could be monitored.[23] If a significant departure from target is detected in financial flows, it would be up to them to explain this difference. Finally, on the basis of an agreed and transparent framework, governments could be required to provide estimates of off-budget liabilities, of their net asset position and of long-term budgetary trends.[24] Estimates should be revised every year. Changes should be extensively explained. These reforms would greatly improve the capacity of the general public and financial markets to evaluate budgetary positions.

Proposal 3: Tackling misbehaviour in good times. It is widely recognised that the SGP does not provide sufficient incentives for countries to run prudent fiscal policies in good times. Within the boundaries of the current rules, a two-pronged approach would be the following: first, devise a sanction to punish early slippages in good times, and second, facilitate prudent behaviour in periods of upturn. In order to step up peer pressure, a possible solution could be that of using the early warning procedure of the SGP not only in bad times when the deficit approaches the 3% ceiling, but also in good times when a significant divergence from structural targets is detected. The current formulation of the early warning provisions tends to exclude their use in the absence of the risk of an excessive deficit. A political agreement would be required to allow a more extensive use of the early warning procedure. The introduction of *rainy-day funds* may improve policies in good times. These are reserve funds that would be used in times of recession and replenished in upturns. Rainy-day funds are used by several US states and Canadian provinces to buffer the effects of unexpected negative events and cyclical downturns.[25] These funds might increase the incentive for governments not to waste the surpluses in good times and increase the room for manoeuvre in bad times. They would also increase the role of public budgets in stabilising the economy over the cycle. The establishment of rainy-day funds would imply a review of the current ESA accounting rules for calculating budgetary indicators. In the current interpretation of national accounts, transfers of resources to and withdrawals from the fund are financial operations (below the line) and hence deficit-neutral. A revised interpretation should establish that transfer of resources to the fund in good times reduces the budget surplus while withdrawal from the fund in bad times is considered as additional revenue and thus reduces the deficit. There should be some rule to ensure that rainy-day funds are used only in recessions. The possibility of establishing rainy-day funds would not obviously tackle at the root the incentive problem that governments have in good times. However, the flexibility that they would provide would allow a tightening of sanctioning procedures for countries exceeding the 3% limit. For instance, the payment of the non-interest bearing deposit could be accelerated and the closeness clause (the amount by which the 3% limit can be exceeded) could be defined in a strict way.

Proposal 4: Non-partisan implementation of the rules. A strong criticism of the Treaty and the SGP is

[22] This is one of the salient features of the new strategy for the implementation of the SGP put forward by the Commission on 24 September 2002. The Commission suggests defining structural adjustment as a change in the budget balance net of cyclical effects and of one-off measures. With the exception of France, the Eurogroup on 7 October 2002 broadly endorsed the Commission proposals.

[23] See F. Balassone, D. Franco, S. Zotteri: Fiscal Rules: Indicators and Underlying Statistical Frameworks, Banca d'Italia 2002, mimeo.

[24] A first step in this direction is represented by the indication to introduce long-term expenditure projections in the stability programmes.

[25] See B. Knight, A. Levinson: Rainy Day Funds and State Government Savings, in: National Tax Journal, Vol. 52, No. 3, 1999, pp. 459-472; and L. McGranahan: State Budgets and the Business Cycle: Implications for the Federal Balanced Budget Amendment Debate, Federal Reserve Bank of Chicago 1999, mimeo, for the US experience.

that enforcement is partisan: national authorities are supposed to apply the rules to themselves, thereby having incentives for collusion and horse-trading. In order to move to a non-partisan implementation of the rules, one has to distinguish between three types of decisions which need to be taken in the implementation of the SGP: (a) technical decisions on the compliance with the rules; (b) political decisions on measures to be taken to prevent or correct an excessive deficit; and (c) implementation of sanctions. The Commission should be entrusted with the implementation of decision (a). This implies that the Commission should be entitled to deliver the first early warning and to determine the existence of an excessive deficit. The Commission, without requiring the approval by the Council, would also assess whether exceptional circumstances apply. The Council should take decision (b) on the measures to be implemented to correct the fiscal imbalance. Hence, the Council should decide on the second early warning, which requires it to specify the corrective measures. As prescribed by current rules, the decision would be taken by the Council on a qualified majority basis following a recommendation by the Commission. Decision (c) on the application of sanctions is of both a technical and a political nature. Leaving it exclusively to the Commission would be unthinkable. A solution that would reduce the risk of a partisan (non-) application of sanctions would be to move from a Commission *recommendation* to a Commission *proposal*. The difference is that the Council can move away from the Commission proposal only with unanimity and not with a qualified majority as in the case of a Commission recommendation. These changes are consistent with the spirit of the current rules. However, in order to be implemented fully, a change in the Treaty would be required. If agreement on the principle is achieved, this could be enshrined in a European Council resolution, which would state that, in the case of the technical decisions, the Council commits itself to reject the Commission recommendations only with unanimity. The crucial question is, of course, whether or not the Council is prepared to strengthen the authority of the Commission in the interest of the credibility of EU fiscal rules. While taken on its own this shift could encounter political resistance; seen within an overall package of sticks and carrots, it would have a better chance of rallying the necessary political consensus.

Conclusion

While we are sceptical of re-opening the debate on the SGP,[26] we think that its functioning can nonetheless be improved. Our main proposals concern redefining the medium-term budgetary targets, improving transparency, tackling the pro-cyclical fiscal bias in good times, moving towards non-partisan application of the rules and improving transparency in the data. This set of ideas allows the achievement of both stronger discipline and higher flexibility and can be implemented without requiring any major revision of the existing rules. These proposals do not provide a recipe for tackling the problems encountered by countries still in transition towards lower deficits in the event of a cyclical slump. Nevertheless, if implemented, they would limit the type of behaviour which is largely responsible for the current fiscal tensions.

[26] See also M. Buti, S. Eijffinger, D. Franco, op. cit.

Carsten Hefeker*

Credible At Last? Reforming the Stability Pact

There are good reasons to criticise the Stability Pact. Apart from its vague economic foundation, its rules are arbitrary and hard to justify. The main argument for creating the Pact in the first place is also no longer valid. So a reform of the Pact would be welcome. But however well founded, the ignoring of the Pact by some governments and the discussion about reform has shattered its credibility. It is thus essential that any reform of the Pact contribute to the restoration of its credibility.

* Head of the Department "World Economy", Hamburg Institute of International Economics (HWWA), Germany.

The current debate over the Stability and Growth Pact once again raises the question of the sense and nonsense of the whole idea. If we believe, as some do, that the Pact was not justifiable on economic grounds in the first place, its de facto suspension is a good thing. If we believe, on the other hand, that there are good reasons for the existence of the Pact and that its suspension is a bad sign for monetary stability and the credibility of the euro, further discussion about the Pact can only make the situation worse. Thus, any reform proposal has to been seen against the background of what the Stability Pact is considered to be needed for and what it should provide. But apart from this more technical question, the Stability Pact has always been grounded at least as much in its credibility. These two functions of the Pact have to be separated and unfortunately it is the second dimension which is the more important and which is damaged most by the discussion. Consequently, any redesign of the Pact has to pay special attention to this fact.

Sense and Nonsense of the Stability Pact

Much has been said about the Stability Pact and the special rules that it prescribes for fiscal policy. Its logic is based on the entry criteria for monetary union, stipulated in the Maastricht treaty. The overall debt-to-GDP ratio should not be above 60 per cent, and the current deficit should not be above 3 per cent. Since the 60 per cent rule has largely been discarded with the decision on who should be admitted to monetary union, attention is directed to the 3 per cent rule. But 3 per cent is the maximum deficit permissible. In "normal" times the budget should be "close to balance". Thus governments should aim for a balanced budget and allow for a deficit of 3 per cent only in business cycle troughs. The Commission monitors governments' fiscal policy (in the same way as it monitors other economic policies) and issues a warning if it expects that a member will violate the 3 per cent. If governments do not take measures or are simply not able to bring their deficits to under 3 per cent, a violation of the Stability Pact will be formally declared and the government will be asked to correct its fiscal position. If the government again fails to do so, it has to deposit a considerable sum in Brussels (ranging from 0.2 to 0.5 per cent of GDP). If the government further fails to bring its deficit down the deposit will be converted into a fine. However, the formal declaration of a violation will be automatically suspended if the GDP of the country concerned has declined by more than 2 per cent during that year. If it has declined between 0.75 and 2 per cent, the process can be suspended.

But why this rule? The underlying reason for having such a rule is the fear that an excessive deficit could have repercussions on monetary policy. It is feared that if one member country runs up a large debt burden it could try to push the central bank toward an inflationary policy to lower the real value of the outstanding debt. The outstanding debt would also push up the interest rate, which might have negative effects on economic activity. This might prompt the central bank into an expansive monetary policy in order to counter the negative effects of a higher interest rate.

Does this argument make much sense? Not really. The European Central Bank is independent in order to avoid exactly this kind of government influence on its policy. And the ECB has shown itself to be very concerned with defending its independence. Moreover, the ECB has been given the explicit mandate to keep inflation low, without paying consideration to other developments in the economy if this would compromise the inflation objective. This is intended to prevent the ECB taking any action to counter negative developments by running an inflationary policy. Thus, the underlying logic of the Stability Pact is in contrast to the independence of the ECB (or should it be read as meaning that governments do not take independence very seriously?) There is hence only a somewhat shaky and inconsistent economic logic between monetary union and the Stability Pact. Nonetheless, the Pact might have been necessary to sell monetary union to the European public, in particular to the German public, which was afraid of an increase of inflation as a result of giving up the D-mark.

The Failure of the Stability Pact

If, as this implies, the main function of the Stability Pact is political in that it is intended to give credibility to the new money's stability then its success should be seen in this light as well. From this perspective the history of the Stability Pact is a short and unhappy one. Its reputation had been impaired even before the physical introduction of euro coins and notes. The German government, threatened with an official warning that it might violate the 3 per cent rule, took action to prevent the Stability Pact working as planned. A pending election was reason enough to have the official rules suspended. Little wonder that other governments followed. In the meantime several governments have publicly declared that, in a similar economic situation, they would simply disregard the Stability Pact.

At the same time, discussion began on how the Stability Pact could be transformed or "reinterpreted". A malign interpretation of the reform talk would be that the Pact should be made less threatening to the governments. A benign interpretation is that a reform would put more economic sense into the Pact. Since its rules are largely arbitrary, it might make sense to look for a more meaningful definition of fiscal stability than a strict 3 per cent of GDP. Hence, it has been suggested that the deficit be cyclically adjusted so that only structural deficits are counted in the 3 per cent. Since, however, structural deficits are not clearly defined, this comes close to inviting all kinds of manipulation of the official figures. In addition, it has been argued that the violation of the 3 per cent rule, which is usually attributed to follow from the cyclical downturn of the world economy, is only a business cycle phenomenon. If, however, as some observers argue the trend growth-rate is closer to a mere 1.5 per cent, most of the deficits have to be considered as structural deficits.[1] Hence not much is gained by concentrating on the structural deficit if it is so close to the measured deficit. In this case, governments would not be off the hook and the chances are that more “creative” methods of calculating structural deficits would be tested.

Another proposal is to consider the 3 per cent as a manifestation of the “golden rule”. In this view, deficits are allowed to be as high as public investments. Something like this rule is applied in the UK, and Germany’s constitution has a similar provision. But since national rates of investment vary considerably in Europe, a meaningful interpretation of such a golden rule would necessarily be that acceptable deficits differ across countries. This would make application difficult. Also, there are serious measurement problems with such a golden rule. What would be the right interpretation of an investment: are teachers’ salaries consumption while government building are investments, for example? Since these categories are highly arbitrary such a rule does not make much sense either.

Apart from these problems with the reform proposals, they destroy the credibility of the Stability Pact because they basically amount to disregarding or bending its rules. Even worse, the impression is that those countries that have taken it seriously and tried to bring down their deficits to close to zero (or even into positive terrain) look pretty silly now. Those that have not been able to reform their social security systems and their labour markets, in contrast, might get away with it. France at least has already declared that it would neglect even a formal warning from ECOFIN.

The Dilemma of Reform

The irony of the situation is that even though the credibility of the Stability Pact is shaken if not completely destroyed, the credibility of the ECB has survived unscathed. No one any longer seems to fear that the ECB could feel pressured into an expansive monetary policy by the fact that some member states run a lax fiscal policy. Therefore, the official reason for the Stability Pact is no longer given. Since the arguments for having the Pact have been weak, and given that it is no longer needed to ensure monetary stability, why not let it die a quiet death?

The problem is that there are other reasons why governments (and the European public) should want something like the Pact that puts a restriction on fiscal deficits and debts. Reasons could be found in the worsening demographic situation, which suggests that governments should prepare for higher expenditures on social security in the future, or in the general political tendency to have generous expenditures and low tax burdens in order to keep the electorate happy.[2] The Pact could be a convenient commit mechanism for such a policy. Governments could use the reference to the European rule to convince domestic interest groups that a change in fiscal policy was necessary. Pointing to Brussels might help them to implement measures that would otherwise not be politically acceptable. While such a rule is also conceivable on a purely national basis, it might be more credible if there were an international treaty behind it. Thus most people would agree, for various reasons, that the general idea of having something like a Stability Pact makes sense, in particular as governments tend to have an overly short time-horizon.

But if the general arguments for a prudent fiscal policy are taken seriously, it must also be acknowledged that a strict rule might not be the right solution for all countries at all times. Especially, it should be taken into account that countries face quite different situations with regard to their demography and thus to their future liabilities. Moreover, countries that already have a large amount of debt are in a worse situation than those with low amounts of debt. Finally, given the present state of the business cycle a more restrictive fiscal policy would be counterproductive to employment and growth.

In recognition of these problems, Commissioner Solbes had at one point himself proposed changes to the Pact. He proposed that the rules should be handled more or less strictly depending on the fiscal situation of the country in question. Those close to or above the 60 per cent should be treated differently from those with a smaller debt burden. The latter should be given more room for cyclical adjustments even if they violate the 3 per cent. If overall debt is the focus of the Pact this makes sense. Also, he has declared that he will not insist that Germany be formally declared in violation of the Pact if the cyclical situation gets worse and if a detailed plan is presented as to how the structural problems that underlie the deficit are to be attacked. This too makes sense because insisting in the current situation that the deficit be

[1] See D. Gros: Should the Stability Pact be Reformed?, Briefing Paper for the Monetary Committee of the European Parliament, December 2002.

[2] It could also be argued, however, that a change in the pension system from pay-as-you-go to a capital based one might require higher deficits to distribute the costs of doing so across several generations; see W. Buiter and C. Grafe: Patching Up the Pact, European Bank for Reconstruction and Development, unpublished manuscript, July 2002.

corrected, meaning that taxes be further increased because there is little political will to cut expenditures, would obviously only worsen the dismal state of the German economy.

This is an obvious time-consistency problem because in general everybody agrees that a rule is better than full discretion but in the concrete situation it is preferred to have more flexibility. In other words, a mechanism is sought that could take account of national developments and differences but retain credibility at the same time.

Can Credibility Be Restored?

How can this problem be solved in future and do the proposals that are currently on the table bring us nearer to a possible solution? To answer this it is useful to see how the problem has been solved in other areas of economic policymaking. The area where the problem has been most obvious and where a solution has been found is – monetary policy. In monetary policy a similar time-consistency problem exists in that it would be best to promise zero inflation ex-ante and, after all nominal contracts have been fixed, to surprise everybody with positive inflation to increase employment and to lower the real debt burden. By transferring policy authority to an independent agent that is not motivated by short-run political interests, the ex-post manipulation of monetary policy can be avoided. Despite initial resistance governments have, perhaps reluctantly, come around to the view that independent monetary policy yields better results than discretion.

So why not have a similar solution for fiscal policy? Why not delegate fiscal policy to a council of independent experts who take care that budget deficits can be kept to zero or in a prescribed range? This would not necessarily mean that cyclical components cannot be taken into account, but at least over the cycle the budget would be in balance. And it could ensure that governments attack structural problems in due time because they would have to accept that there is no way to shift fiscal policy toward an expansive course if an independent council protects the integrity of the budget.[3]

Such an independent fiscal council, it has to be stressed, would not imply that the government loses its power of decision concerning the structure of taxation and spending, nor concerning the size of the government budget. It would only ensure that expenditures and revenues have the same size if a budget deficit of zero is considered appropriate. The council should be independent with a long and non-renewable term of office and it should be impossible to remove its members unless they violate their obligations. They would control the budget bill and if it threatens to violate the deficit aim, the council would have the authority to implement automatic tax increases or spending cuts to keep the budget within its limits. In cases of major unforeseen events, the council would be able to declare a suspension of the budget rule for a given year.

Moreover, if it were feared that the fiscal council could pursue a policy that was not in the interest of the electorate, the head of the council could be obligated to testify before parliament to explain and justify its policy target. Alternatively, it is conceivable that the government and the council negotiate a target level for the budget deficit, which the council is then expected to implement. This would be akin to an inflation target such as those operated by an increasing number of central banks. As with inflation targets, there should be enough flexibility to account for unforeseen circumstances, so that the target could be violated in a single year but over the cycle the actual deficit would have to be close to the target. To make the council even more accountable, the case of contracts with the council could be considered, stipulating that the council would lose office if its failed to implement its target.[4] All these measures, which work well in monetary policy, should at the same give the government some autonomy over the budget and the needed flexibility for unforeseen situations, but preserve the credibility of fiscal policy because there is an institutional mechanism that protects it.

In contrast to the proposals for reform that are currently being discussed in Brussels or in the national capitals such a solution could restore the credibility of fiscal policy. A fiscal rule can only be credible if future political manipulations are ruled out. This can only be achieved by taking the right of decision concerning formal violations of the Pact away from the government. Otherwise there will always be a discussion about the implementation of the Stability Pact and whether it will be enforced. It would be a much cleaner solution, and a much more credible one, to transfer the task of supervision to a truly independent council. Even if this sounds like social science fiction, it should not be forgotten that the same idea, when first expressed for monetary policy in the 1980s, was just as unlikely to be accepted by a large number of countries. Maybe this time governments will come around to a new idea a bit faster.

---

[3] For details on such a council, see C. Wyplosz: Fiscal Policy: Institutions vs. Rules, Graduate Institute for International Studies, unpublished manuscript, December 2001.

[4] For a discussion of the alternative solutions regarding monetary policy, see B. Hayo and C. Hefeker: Reconsidering Central Bank Independence, in: European Journal of Political Economy, No. 18, 2002, pp. 653-674.