The Stability and Growth Pact in Need of Reform

The failure of an increasing number of countries to comply with the rules of the Stability and Growth Pact has given fresh impetus to the debate on the appropriateness of the Pact in its present form. This Forum deals with the deficiencies of the present design of the Pact and with possible ways of improving it, including the pertinent proposals by the European Commission.

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Proposals for a Better Stability Pact

Since November 2003, when the Stability and Growth Pact (SGP) was effectively abandoned, ways have been sought to reach a new and more firmly anchored framework for budgetary policy. The Netherlands in particular is pushing for greater legislative powers for the SGP, to be enshrined for instance in the new European constitution. However, the wisdom of this must surely be questioned. The SGP contains a number of flaws which effectively brought about the crisis surrounding the pact. Lending more weight to a poorly structured pact can only mean that the political fallout will be even greater after the next crisis. At the same time, the collapse of the SGP has generated the opportunity to create a better pact. The aim of this article is to explore ways in which this might be achieved.

The terms of the Maastricht Treaty, which were hammered out in 1991, include the accession criteria for participation in the European Monetary Union. The most important criteria concerned budgetary policy, and set a threshold of 3% of GDP for the general government deficit and a ceiling of 60% of GDP for gross public debt.

In 1991, the average general government deficit in the later eurozone was 5.0% of GDP; by 1999 it had decreased to 1.3%. The debt ratio, on the other hand, rose initially, but since 1996 has been following a downward line, although this has been interrupted since 2002.

The Stability and Growth Pact

The SGP, which dates from 1997, is essentially the sequel to the Maastricht Treaty. It came about because Germany, in particular, was concerned about the budgetary framework in EMU. While the Maastricht Treaty was a successful transitional solution, it fell short as a guideline for budgetary policy in the member states once they had entered the eurozone.

The SGP set the standard for maximum future permitted government deficits in EMU also at 3% of GDP. Theoretically, a country should have accumulated sufficient financial room during normal times by achieving a balance or even surplus on its budget to enable the so-called "automatic stabilisers" to work during a recession.[1]

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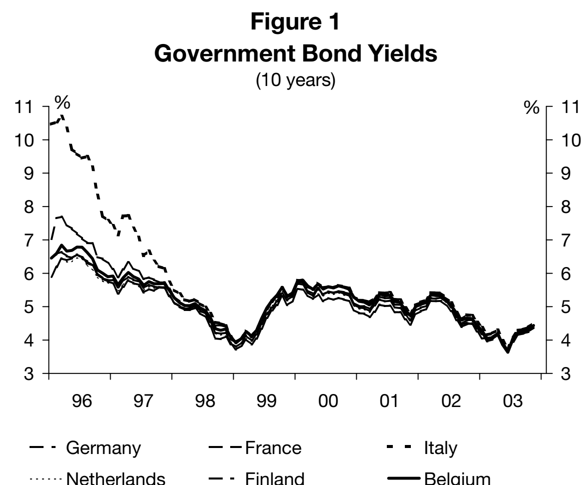
During a period of economic growth and budgetary equilibrium in the economic cycle, government debt will decrease as a percentage of GDP. Accordingly, if the pact is strictly complied with, the collective debt ratio of a member state should decline steadily and ultimately become a net surplus.[2]

However, a number of arguments can be made against the fundamental design of the SGP. First, the agreed budgetary standards, just as in the Maastricht Treaty, are rather arbitrary. There is no clear case to be made for why a government deficit should not be allowed to exceed 3% of GDP. In the case of the Maastricht Treaty, which was a transitional framework, this is not a problem, because a maximum deficit of 3% represented a distinct improvement on the existing situation in 1991. Certainly, the improvement proved sufficient to reverse the rising trend in government debt ratios. By contrast, for a pact such as the SGP, which is effectively intended to be permanent, the poor basis for the standards constitutes a greater problem, particularly if these standards should already start to show cracks early on.

A second argument is that a group of countries as diverse as the EMU participants cannot realistically be subjected to a uniform deficit limit. Italy and Belgium, for instance, with their already excessive public debt should really have a surplus on their government budget. Conversely, countries with a low debt could afford to have a higher public deficit for lengthy periods without jeopardising the sustainability of their government finances. This also applies to a country such as the Netherlands, which is the only country in EMU to have provided for a considerable proportion of its future pension obligations by means of a capital-funding based pensions system. For countries with above-average trend growth, a greater deficit is less likely to be expressed in a rising national debt ratio. The greater the number of countries in EMU, the more diverse is its constellation, which casts doubt on the wisdom of trying to make do with a single deficit standard.

Figure 1
Government Bond Yields
(10 years)



Source: Thomson Financial Datastream.

Finally, unlike the Maastricht Treaty sanctions, the penalties for failure to comply with the budgetary terms of the pact are difficult to impose. In the former case, the sanctions were clear-cut: exclusion from EMU.

Should We Just Forget the Pact?

What if we consider doing without budgetary standards? By improving the transparency of national budgets, together with regular monitoring by the European Commission, the market can be supplied with even better information. Rating agencies could also play a part in this. With the "no bail out" clause of the Maastricht Treaty[3] lurking in the background, the financial markets will ultimately put pressure on the countries with a poor budgetary policy, forcing them to put their house in order.

The main advantage of this approach is its institutional simplicity. No special measures are required. It also does justice to the subsidiarity principle, which presupposes that budgetary policy is first and foremost a national matter. Likewise, it addresses the lack of logic in a system where greater attention is paid to reaching consensus on budgetary policy than to policies on a number of other, no less important areas. These include labour market policy, growth-inhibiting measures, the reform of social security and the reorganisation of pension funds,[4] all areas where the

[1] For more information on the Stability and Growth Pact, cf. S. C. W. Eijffinger, J. de Haan: European Monetary and Fiscal Policy, Oxford 2000, Oxford University Press; or H. Visser: Verwarring over het Stabiliteits- en Groeipact (Confusion about the Stability and Growth Pact), in: Maandschrift Economie, No. 66, 2002, pp. 425-434.

[2] This net creditor position must clearly be re-invested in securities, such as foreign government bonds, corporate bonds and/or shares. Buiter observes in this context: "It is ironic that the Stability and Growth Pact may have as one of its implications the partial socialisation of the means of production in the long run." W. H. Buiter: How to reform the Stability and Growth Pact, mimeo, January 2003.

[3] Maastricht Treaty, article 104 B.

[4] Cf. C. van Ewijk, R. A. de Mooij, P. J. G. Tang: Dom Stabiliteitspact (Stupid stability pact), in: Economisch Statistische Berichten, 1 November 2002, pp. 780-782.

knock-on effects of poor policy in one member state are at least as great in neighbouring states as defective budgetary policy. Yet the responsibility for policy in these areas is left entirely up to the individual governments.

The problem with this "laissez-faire" approach is that the financial markets are poorly equipped to distinguish between the various EMU member states. The minor differences in interest rates on government bonds within EMU generate no disciplinary effect whatever. The interest rate differentials that existed in the pre-euro area chiefly reflected the exchange-rate risk. Since 1998, the differences in yield on government bonds have been negligible (cf. Figure 1).

Based on the quality of government finances, it might be expected that the financial markets would demand a higher yield from, for example, Italian and Belgian government paper and a lower yield for Finnish bonds than the benchmark – which is Germany. In reality, however, the financial markets take a more or less identical view of the solvency – or risk of government bankruptcy – of all the countries within EMU. Consequently, it is not a good idea to leave the job of monitoring budgetary policy solely to the workings of the financial markets, and try to manage without a pact. The European bond market does not have sufficient powers of discernment for this job.

Criteria for a Better Pact

A new pact is needed, but it must be a better one. A better pact will have to meet a number of conditions, if it is to be sustainable in the long run. The most important criteria for a good pact are listed below.

- The terms agreed should do justice to the importance of the sustainability of government finances in the long term, by restoring the balance in the relative importance of national debt and deficit standards, paying greater attention to the former and less one-sided attention to the latter.
- The pact should take account of the large variation in structure, economic cycle, demographics and stage of development of the EMU member states.
- In the absence of a European central government budget, there should be consensus on allowing a greater degree of flexibility within EMU for the budgetary policy of smaller countries in particular, whose business cycle will relatively often fall out of step with the EMU average.
- The terms must be clear and allow no room for political bartering. There must be complete transparency in the criteria, so that it will be crystal clear to everyone whether the limits have been breached, and if so sanctions will automatically follow.
- The sanctions should be straightforward to impose. They should ideally be preceded by a period of "warning pains" that become increasingly intense as the danger zone approaches. This warning period should preferably include at least one election cycle, so that voters can have the chance to dismiss irresponsible policymakers.
- The ultimate sanctions must be genuine deterrents. This was the case, for instance, with the Maastricht Treaty. The threat of being excluded from EMU had far greater effect than the more abstract consequences of derailed government finances, such as a higher interest-rate burden and unsustainability in the long term.[5] Experience shows that financial discipline goes a-begging as long as politicians remain unpunished in passing on the cost of poor policy to subsequent generations, particularly where voters do not feel the negative consequences of the current policy, or may even benefit from it in the short term. By contrast, acute loss of face such as exclusion from important European decision-making processes has a very disciplinary effect.

Government Debt a Better Guideline

A new Stability and Growth Pact should therefore not only focus on setting a standard for the government deficit, but instead should concentrate more on the size of the government debt. The preference within EMU for reaching budgetary standards is, after all, based on concerns about the sustainability of public finances in the long term, partly on account of the financial burden of an ageing population. However, these concerns would be much better addressed by a standard for national debt, which in many respects could be read as an indication of the solvency of a national government sector. The gross debt standard used in the Maastricht Treaty could be corrected for detailed, income-generating government assets. Information on net debt obtained in this way gives important insight into the health of a country's government finances. This approach would also avert moves

[5] J. Vuchelen: Verschuivingen in de belangstelling voor het overheidstekort (A shift in focus on government deficit), in: Tijdschrift voor Politieke Ekonomie, Vol. 25, No. 1, December 2003, pp. 51-80.

towards the privatisation of public companies purely for budgetary reasons, particularly in cases where society benefits more from keeping certain utility services or "natural monopolies" in public ownership.

One advantage of a debt ceiling is that it will draw attention to those countries that really do constitute a threat to financial stability in Europe. It was rather strange that during the debate on the SGP in 2003 most criticism was directed at Germany and France as the main culprits, whereas Italy with its still too high national debt escaped unaccused, because the Italian deficit was just under 3% of GDP. Likewise, the fact that the Netherlands – the only EMU country to have made reasonably adequate pension provision in the form of capital funding – is currently standing in the dock, also indicates that there is something wrong with the SGP criteria.

A second argument in favour of a debt standard is that it will provide greater room for a flexible budgetary policy – with sufficient scope for the automatic stabilisers – than a deficit threshold. This is important in view of an expanding EMU, because smaller countries in particular are more likely to fall out of step in terms of the average economic cycle. They are then confronted with a monetary policy that is insufficiently tailored to their situation. By joining EMU, and relinquishing their own monetary policy as well as their own exchange rate, the member states need greater flexibility in budgetary policy, in order to be able to absorb whatever shocks may occur.

Thirdly, a debt standard will in due course permit newcomers to EMU who have above-average trend growth to have a more sizeable government deficit. Because of their higher growth rate, compared to the "old" member states, a higher budget deficit will have little or no impact on their debt ratio. Taking all these arguments into account, a debt standard would far better reflect the subsidiarity principle: countries having considerable autonomy in devising their own budgetary policy.

As we argued above with respect to a deficit standard, equally there are no objective criteria for an "optimum debt ratio". What we do know is that experience has shown that some European countries have, in the past, been able to manage reasonably well with a debt ratio of over 120% of GDP. A lower threshold is necessary in EMU, because the member states no longer have instruments such as currency devaluation and monetary financing at their disposal. The back door of inflation is no longer there, which was used to prevent the debt ratio from rising too high. However, once a debt standard has been fixed, it is straightforward and clear to interpret.

Effective Sanctions

For a new Stability Pact to be able to exact compliance, it must contain sanctions which meet the following criteria: the sanctions must be straightforward and effective. These criteria are preferably found in the area of politics and policy-making. A first sanction, for instance, might be loss of voting rights in the European Central Bank. Loss of franchise in the Council of Ministers with regard to financial matters would also be a possibility. It would deter countries with a high national debt from the tendency to embed an inflationary bias in their policy. An ultimate sanction – to be imposed if the pact is blatantly ignored – would be to suspend the European Commissioners of the offending member states. Financial sanctions could be sought in loss of support from European funds or suspension or discontinuation of participation in the Common Agricultural Policy. Sanctions of this nature would result in such political loss of face that no country would presumably ever let things get that far.[6]

Central Financing to Supplement the Pact

It would clearly be welcome if the financial markets were able to distinguish better between countries with a poor budgetary policy and those with more solid public finances. Then, long before the threat of political sanctions, the markets would gradually begin to "punish" the countries pursuing bad budgetary policies. The good performers would be rewarded with lower interest rate charges. This process would directly have the effect of the kind of warning signals alluded to above, which are picked up long before a country really gets into trouble.

The discerning powers of the markets might possibly be restored by including central financing of government deficits in the terms of the budgetary agreements. Under these terms, the individual coun-

[6] For a detailed example, cf. W. W. Boonstra: Een nieuw stabiliteitspact? (A new stability pact?), in: Economisch kwartaalbericht, Rabobank, March.

[7] Cf. I. J. M. Arnold: The Third leg of the Stool. Financial Stability as a prerequisite for EMU, in: Weltwirtschaftliches Archiv, 1999.

tries would have to agree not to seek funding for their deficits on the financial markets themselves. They would thus forfeit the right to issue their own government bonds. Instead, a European body would be set up – we shall call it the EMU Fund – which would borrow the required funds on the financial markets and subsequently lend them to the member states. In this way, the EMU Fund would maintain a spread in relation to its own funding costs, which would depend on the relative quality of the government finances of the member states.

The main advantages of this scenario would be three-fold. First the route of indirect monetary financing (financing government deficits by local banks buying up public debt) would be cut off.[7] Second, the average financing costs would be reduced as a result of the creation of a new, sizeable, very liquid benchmark on the euro-bond market (also as a benchmark for other issuers) and third, the disciplinary effect of financial markets would be reinforced. Clearly there would be disadvantages as well, particularly for countries with a relatively poor budgetary policy, because these would be confronted more readily than now with relatively high interest-rate charges. On the other hand, there is a clear advantage for the financially more solid countries, because they would be rewarded with lower interest charges by the EMU Fund.[8] In this way, the EMU Fund would be able to function as an early warning indicator for policymakers that their policies are unfolding in the wrong direction.

Calculation of the Spread

Figure 2 shows how the spread is calculated on the basis of the formula:

$$o_{it} = \alpha(T_{it} - T_{EMU(t)}) + \beta(S_{i(t-1)} - S_{EMU(t-1)})$$

where:

o_{it} = premium of country i in year t

α = parameter for government deficit

T_{it} = government deficit (%GDP) country i in year t

$T_{EMU(t)}$ = government deficit (%GDP) entire EMU in year t

β = parameter for the national debt

$S_{i(t-1)}$ = national debt (%GDP) country i in year (t-1)

$S_{EMU(t-1)}$ = national debt (%GDP) EMU in year (t-1)

Consequently, the spread to be paid is chiefly determined by the α and β parameters, in addition to the relative government deficit and public debt ratio.

Setting these parameters, which have to be the same for all countries, is by definition arbitrary. Two questions have to be addressed in this respect. The first question concerns the relative sensitivity to government deficit and debt development respectively in the participating countries, i.e. what should the *relative* value of the α and β parameters be? On the one hand, it has been argued above that the national debt should be weighted more heavily; on the other hand sensitivity to the budget deficit must be taken into account. The budget deficit is easier to influence in the short term, and essentially pre-empts the development of the national debt. Consequently, "good" fiscal policies can be rewarded relatively quickly with a lower spread, and "bad" policy punished with a higher spread.

The second matter concerns the *absolute* value of the parameters. In effect, this touches on the underlying question: how high should the maximum spread be? The answers to both questions should be hammered out in advance, prior to the establishment of the EMU Fund.

A Numerical Example

In the example below, the α and β parameters have, for the sake of argument, been set at 0.0075 and 0.0375. Based on the actual deficit development and public debt ratios for the years 1999-2002, this would have resulted in the interest rate trend shown in Figure 2.[9]

Figure 3 shows how, on the basis of the parameters used, the interest rates calculated would relate to the actual yields in the period under review. Both graphs show that Italy can indeed be regarded as the main free rider of EMU. Despite an excessively high national debt and an ongoing relatively high deficit, the effective yield on Italian government bonds is currently scarcely higher than on German or French govern-

[8] The concept of an EMU Fund dates from 1989. Cf. W. W. Boonstra: Het EMU-fonds. Ei van Columbus? (The EMU Fund. "Eureka"?), in: Economisch Statistische Berichten, 6 December 1989, pp. 1208-1215; or by the same author: The EMU and national autonomy on budget issues: an alternative to the Delors and free market approaches, in: R. O'Brien and S. Hewin (eds.): Finance and the international economy: 4, Oxford 1991, Oxford University Press, pp. 209-224. The idea of using the EMU Fund as an ancillary to budgetary agreement is derived from L. H. Hoogduin: Het EMU-fonds: een commentaar (The EMU Fund: some observations), in: Tijdschrift voor Politieke Ekonomie, Vol. 21, No. 4, October 1999, pp. 112-117. Cf. also Y.-T. De Silguy: The euro, the key to Europe's lasting success in the global economy, address to the Corporation of London, 26 July 1999.

Figure 2
Development of Hypothetical EMU-Fund Interest Rates
(1999-2002)

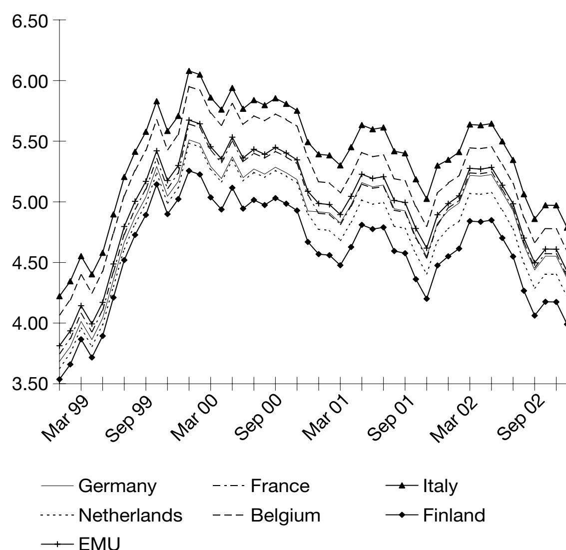
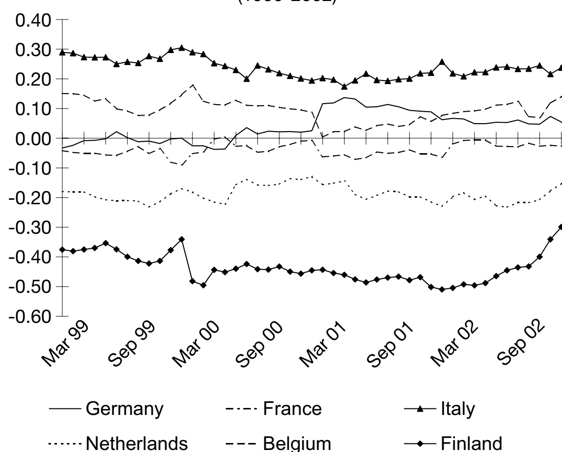


Figure 3
Comparing Hypothetical Interest Rates with Actual Yields
(1999-2002)



ment bonds. By positioning the EMU Fund between the debtors and the capital market, Italy would be "penalised" for its poor public finances.[10]

In this example, the maximum spreads calculated amount to some 40 basis points above or below average. Clearly, it is possible to increase this spread of some 80 basis points by giving the α and β parameters a different value. The relative sensitivity to deficit and debt trends can be changed by adjusting the relative values of the parameters (1:5 in the example).

Conclusion

Every European agreement is based on the understanding that the participating countries are behind the terms agreed. Agreements that are to stand up in the future also have to be as objective as possible, and it must be possible to establish clearly and unequivocally whether the countries are keeping to the terms of the agreement. This is indeed possible in the approach proposed in this article. The European Court of Auditors and/or Eurostat can easily ascertain whether a threshold has been exceeded. If necessary, setting up a special committee of experts could be considered.[11]

Sanctions should be straightforward to impose, and should be unavoidable for the country to be penalised. Otherwise, it would be better to dispense with agreements altogether. The sanctions outlined above would meet both these criteria.

On the other hand, doing without budgetary criteria altogether would be less harmful than reanimating a badly flawed pact, which simply will not work when the crunch comes. In other words: adding greater legal authority to the existing badly designed pact would just help to make the future political damage even greater.

Agreements based on the public debt ratio of the member states target the real offenders. We are talking about countries that have been pursuing poor budgetary policy for years and ignore the recommendations of the European Commission and the other member states. By underpinning these agreements with central financing for government deficits, thus restoring the currently lacking disciplinary impact of the financial markets, their effectiveness will be further increased. Plus, no-one will want to buy government bonds from a country that first had to hand over the right to issue bonds to the EMU Fund, only to subsequently issue them again themselves.

New agreements based on the debt ratio and possibly including central deficit financing could result in a rather straightforward yet inherently stronger and more enforceable Stability Pact.

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[9] The EMU Fund rate is determined as the average of the rate actually paid by Italy, France and Germany.

[10] One cannot exclude, however, that the future funding costs of the EMU fund will be lower than the current German yield. If this were the case, it could happen that Italy even with a higher spread would still face lower funding costs than without the EMU fund.

[11] Cf. W. H. Buiter, op. cit.

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Reform of the Stability and Growth Pact: Evaluating the European Commission's Communication of September 2004

Since the first countries broke its rules, the Stability and Growth Pact (SGP) has been under fire, with many arguing for reform and some even for its abolition. Especially the enlargement of the European Union by ten new Member States (that will eventually also join the Euro) has fed the discussion whether the uniform rules of the Pact are still appropriate for countries that are considerably heterogeneous and economically diversified.

In addition to the call for more flexibility, experience has shown that countries do not behave prudently in good times (like under the favourable growth conditions at the end of the 1990s[1]), which indicates that the Pact is asymmetric in nature, not giving the right incentives to fiscal policy-makers during economic upswings.

With respect to enforcement and implementation, the problems of the SGP reached their preliminary climax in November 2003 when the Ecofin suspended a Commission recommendation to start sanction procedures against Germany and France – a decision that has been annulled by the European Court of Justice in July 2004. This Court ruling made a rethinking of the Pact's rationale, rules and implementation unavoidable. As a reaction to the SGP's problems in general and this Court ruling in particular, the European Commission has published on 3 September 2004 a Communication on "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact", in which it presents proposals on how to enhance the effectiveness of the Pact's rules.[2]

In the following, it will be argued that these proposals are a step in the right direction, however improvements are still necessary, especially with respect to partisan enforcement. More specifically, increased flexibility of the rules should go together with enhanced enforcement to prevent that the transparency of the Pact is watered down without actually improving its functioning and implementation.

The recent Communication of the Commission incorporates many of the changes to the SGP as proposed by the literature during the last years. In the following, the Communication's ideas are evaluated based on a comparison with the four specific proposals for reform put forward by Buti, Eijffinger and Franco.[3] Furthermore, some additional considerations are presented.

Excessive Uniformity of the Rules

With regard to the excessive uniformity of the rules, Buti, Eijffinger and Franco[4] proposed to increase the flexibility of the Pact through introducing a country-by-country articulation of the medium-term budgetary target of "close to balance or in surplus". So far, this requires in practice a balanced budget position in cyclically adjusted terms every year throughout the cycle, where countries are only distinguished based on the differences in the cyclical sensitivities of their budget balances. In order to take account of the financial fragility of a country and the threat to long-term sustainability, the level of public debt and contingent liabilities needs to be considered. More specifically, countries with a relatively low stock of debt and low levels of contingent liabilities could be allowed to have cyclically adjusted deficits up to their minimal benchmarks.

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[1] See the European Commission's Communication "Strengthening the co-ordination of budgetary policies" of 27 November 2002.

[2] European Commission: Communication from the Commission to the Council and the European Parliament: Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact, 3 September 2004.

[3] M. Buti, S. Eijffinger, D. Franco: Revisiting EMU's Stability Pact: A Pragmatic Way Forward, in: Oxford Review of Economic Policy, Vol.19, No.1, 2003.

[4] M. Buti, S. Eijffinger, D. Franco, op. cit.; the comparison of the European Commission's Communication of 3 September 2004 with the proposals by Buti, Eijffinger and Franco is summarised in Table 1.

In accordance with these ideas, the Commission suggests to allow for more country-specificities in two ways. Firstly, as a complement to the rigorous surveillance of deficit developments, more attention should be paid to debt and sustainability, e.g. in defining the medium-term deficit objective that would be more stringent the higher the debt level. In particular, it is acknowledged that in addition to initial debt levels, contingent liabilities, public (net) investment needs and country-specific potential growth conditions could be considered. In this context, it should be stressed that common estimates for both contingent liabilities and net investment are needed in order to not open a door to manipulation through different methods of measuring contingent liabilities or misinterpretation of certain expenditures as investment needs.[5]

In addition to the proposals by Buti, Eijffinger and Franco, the Commission also suggests that, once an excessive deficit occurs, the adjustment path prescribed to the Member State should take into account country-specific circumstances instead of imposing uniform deadlines that ignore different cyclical developments and debt levels in the Member State under consideration. This should limit incentives to use one-off measures or to conduct overly restrictive fiscal policies in order to be able to stick to the deadlines. More specifically, either the current deadlines are kept but the definition "special circumstances" is widened to allow for more flexibility, or country-specific deadlines become the rule. Furthermore, it is pointed at the fact that widening the "exceptional circumstances clause" helps to appropriately respond to situations where growth is positive but well below its potential. In such circumstances it is hard to reduce an excessive deficit without depressing growth even further.

Either way, this again calls for a very clear definition of the (extended) timeframe of the deadlines and a restriction of the conditions under which the term "exceptional circumstances" applies. With regard to the latter, it should be prevented that the exception becomes the rule, especially as countries whose deficits are said to be due to exceptional circumstances are not in the Excessive Deficit Procedure (EDP) and hence not under increased surveillance. In general, too much discretion in the interpretation of these terms harms both the transparency and the effectiveness of the Pact and creates possibilities for misuse.

Transparency

Concerning transparency, Buti, Eijffinger and Franco underline that improved transparency is a precondition to more flexibility in the SGP as it helps to limit accounting creativity and therefore strengthens the Pact's credibility. Measures that increase transparency include the clear distinction between one-off and long-lasting measures when assessing a country's budgetary balance, the estimation of off-budget liabilities and long-term budgetary trends and a regular monitoring of cash flows to reconcile the occasionally diverting developments between deficits (flows) and debts (stocks). These measures contribute to a better assessment of the creditworthiness of different Member States and simultaneously give room for more effective peer pressure.

In its recent Communication on the SGP, the Commission acknowledges the importance of transparency but stays more general in its focus on increased transparency in the surveillance activity (e.g. by publishing quantitatively more and qualitatively better information about the Excessive Deficit Procedures of concerned Member States) and its case for increased quality, timeliness and reliability of Member States' fiscal statistics through minimum EU standards for the institutional set-up of statistical authorities.

In addition to what has been proposed by Buti, Eijffinger and Franco and the Commission, in the context of transparency, special attention has also to be given to appropriate forecasts of economic growth. Overly optimistic forecasts that are common in some Member States[6] can translate into higher than projected (and sometimes even excessive) deficits given the fact that government revenues are quite responsive to changes in potential output whereas government spending is less elastic as adjustments on the expenditure side in the budget normally have to go through the lengthy and costly process of political coordination and decision-making. As a consequence, there is the possibility of a "hidden undermining" of the SGP through basing the budget on overly optimistic forecasts of economic growth while formally complying with the Pact's requirements during the budgetary planning process. For this reason, the estimation task should be delegated to a national authority independent from the government (as already present in some Member States). A qualified institution in this respect could for example be the national central bank (NCB)

[5] See the discussion about the "golden rule" as in M. Buti, S. Eijffinger, D. Franco, op. cit., F. Balassone, D. Franco: Public Investment, the Stability Pact and the Golden Rule, in: Fiscal Studies, Vol. 21, No. 2, 2000, pp. 207-29, or W.H. Buiter: Notes on a 'Code for Fiscal Stability', in: Oxford Economic Papers, Vol. 53, No. 1, 2001, pp. 1-19.

[6] For a more detailed discussion of this topic see also J. von Hagen, M. Hallerberg, R. Strauch: Budgetary Forecasts in Europe – The Track Record of Stability and Convergence Programmes, ECB Working Paper, No.307, February 2004.

of Member States having the advantage that the independency of the institution is guaranteed (as it is a precondition for joining EMU) and professional staff as well as tools and appropriate models for forecasting are readily available. Especially in the light of the Council's claim to distinguish measures taken from economic forecasting errors[7] it is crucial to have an independent authority responsible for these forecasts to ensure that such a distinction does not open new ways to hide unsatisfactory efforts to comply with the rules behind inappropriate growth forecasts (which would decrease rather than increase transparency).

Tackling Misbehaviour in Good Times

As a response to the pro-cyclical fiscal bias in good times, Buti, Eijffinger and Franco suggest two measures, namely (1) to make significant deviations from the budgetary targets subject to an early warning procedure even if the deficit is well below the 3% ceiling (or even negative) and (2) to facilitate countries to behave prudently in periods of upturns through the introduction of rainy-day funds. During phases of strong economic growth, resources can be transferred to these funds, which in turn can be used in "bad times" to increase the room for manoeuvre and thus effectively increase the deficit ceiling. In this set-up, the maximum size of accumulated funds could be increased the lower the stock of debt, in other words, the deficit ceiling becomes a negative function of the debt ratio. This should give some incentives to governments not to waste surpluses in good times but instead to transfer them partly to the fund (or alternatively, in case of a high debt level, use them to reduce the debt). For this mechanism to work however, the ESA accounting rules, which currently interpret transfers from and to the fund as deficit-neutral, need to be adjusted.

The idea of an early warning procedure independent of the danger of an excessive deficit (1) has found its way into the Commission's Communication: direct early warnings as foreseen by the Draft Constitution should contribute to signalling early enough inadequate budgetary developments. In contrast, the introduction of rainy-day funds (2) is not considered in the Communication. For the Commission, tackling misbehaviour in good times is inherent in its proposal of country-specific adjustment paths to correct excessive deficits. As outlined above (excessive uniformity of the rules), the medium-term deficit objective and the adjustment path are made dependent on the debt-to-GDP ratio and its sustainability, meaning that a high level of debt and contingent liabilities makes the deficit ceiling more stringent and demands a quicker reduction of excessive deficits than in countries with a relatively low debt-to-GDP ratio and high sustainability.

The crucial difference between these two views on how to remedy the asymmetric nature of the SGP lies in the fact that in the Commission's proposal, countries with a low and sustainable debt-to-GDP ratio still end up with an Excessive Deficit Procedure and the reputation cost connected with it, whereas the introduction of rainy-day funds avoids this. As the two policies are not mutually exclusive but reinforce each other in creating incentives for governments to behave

Table 1
Comparison of the Commission Communication of 3 September 2004 with the Proposals by Buti, Eijffinger and Franco

Buti, Eijffinger & Franco	Commission proposal
1. Overcome excessive uniformity of rules (→ flexibility) - take into account long-term sustainability → contingent liabilities	**Allow for more country-specificities in defining medium-term deficit objective** - more focus on debt and sustainability (→ pensions) - widen exceptional circumstance clause (cover periods of slow growth) - allow for country-specific elements in adjustment path of excessive deficits
2. Increase transparency - monitor cash figures - estimate off-budget liabilities and long-term budgetary trends	**Ensure greater transparency & accountability concerning Member States' budgetary policies** - improved monitoring at EU level of reported data
3. Correct pro-cyclical bias - early warnings in good times - rainy day funds	**Ensure earlier actions to correct inadequate budgetary developments** - direct timely early warnings by the Commission, also in good times
4. Move to non-partisan enforcement - Commission implements the rules, Council decides on policy measures - EDP and sanctions on Commission proposal rather than recommendation	- direct early warnings by Com mission (reference to provision in Constitution: Commission proposal rather than recommendation for Council to launch EDP)

Sources: European Commission: Communication from the Commission to the Council and the European Parliament: Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact, 3 September 2004; M. Buti, S. Eijffinger, D. Franco: Revisiting EMU's Stability Pact: A Pragmatic Way Forward, in: Oxford Review of Economic Policy, Vol. 19, No.1, 2003.

[7] Statement by the EU ministers of Finance on the SGP of 10 September 2004 at the Informal Ecofin meeting in Scheveningen, the Netherlands.

prudently during economic upswings, it would probably be best to combine both policies.

Non-partisan Implementation of the Rules

For Buti, Eijffinger and Franco, ensuring a non-partisan implementation of the rules is the key to a more effective and credible SGP. One of the main problems of the SGP, as particularly visible in the controversial Council decision of 25 November 2003, is the fact that the same ministers of finance who are responsible for drafting the national budgets also have to decide whether they breach the Treaty and the SGP rules. Within the current EU framework of sovereign national states conducting their fiscal policies, it is of course highly unlikely that e.g. the process of drafting budgets could be delegated to a supra-national independent authority. Acknowledging this, Buti, Eijffinger and Franco alternatively plead for a clear distinction of tasks between the Council and the Commission regarding technical decisions, political decisions and implementation of the sanctions. Technical decisions on the compliance with the rules, that is, the determination of the existence of an excessive deficit as well as the following first early warning, should exclusively be taken by the Commission, without approval of the Council. Political decisions on measures to be taken to prevent or correct an excessive deficit should be taken by the Council following a recommendation of the Commission, whereas decisions concerning the implementation of sanctions are of both technical and political nature, thus both Council and Commission should be involved. Buti, Eijffinger and Franco propose to let the Council decide on the sanctions based on a Commission proposal rather than recommendation. This has the advantage that it requires unanimity to move away from a proposal, which strengthens the position of the Commission vis-à-vis the Council. Under this scenario, enforcement stays partly partisan but is improved compared to the current practice. Given that the above-mentioned considerations aim at cutting the power of the Council compared to the status quo, it does not come as a surprise that the Commission is much more reserved/cautious in proposing changes in this respect. In the Communication, it is merely referred to the provisions introduced in the Draft Constitution that foresees, as already mentioned, the issuance of early warnings directly by the Commission and furthermore the launching of the Excessive Deficit Procedure based on Commission proposals rather than recommendations. Even though this strengthens the position of the Commission with regard to technical decisions, it does not address the problem of the partisan decision on sanctions that – as experience has proven – is actually the bigger problem.

Evaluation and Conclusion

The analysis above shows that the proposals presented in the Communication of the Commission of 3 September 2004 largely reflect the ideas put forward by Buti, Eijffinger and Franco[8]. Some of the main problems as identified by the literature including excessive uniformity of the rules, transparency issues and the asymmetry of the Pact, are addressed. However, it has to be stated that the problem of partisan enforcement is not dealt with sufficiently even though this point is of major importance for a balanced approach to reforming the SGP.

The academic literature discussing the SGP often refers to the trade-off between simplicity and flexibility of fiscal rules. Both characteristics are desirable but cannot be achieved simultaneously. At the same time, the need for more flexibility in the Pact is widely acknowledged. Keeping this trade-off in mind, it is therefore of particular importance to give up simplicity if and only if at the same time not only flexibility but also effectiveness through better enforcement of the Pact is enhanced. Less simple (but more flexible) rules without ensured enforcement solely lead to a more complicated framework without actually enhancing fiscal discipline in EMU, which is what the SGP has originally been designed for. The threat of sanctions therefore, be it for small or large Member States, needs to be credible. Otherwise, the fiscal rules do not provide for the right incentives towards prudent fiscal policy-making.

In the light of these considerations, it is fair to say that the Communication of the Commission does imply a step in the right direction, but there is still substantial room for improvement towards a more balanced reform proposal, especially when taking into account that the changes regarding enforcement put forward by the Commission only materialise when the Draft Constitution will be ratified. This will certainly be a lengthy process (if ratification takes place at all). Increasing the flexibility of the Pact without simultaneously properly addressing the issue of enforcement will be watering down both transparency and credibility while lacking to enhance the Pact's functioning and implementation. If the declared goal of the Commission is increasing the Pact's effectiveness,[9] it should take this into account.

[8] For an overview see Table 1.

[9] As stated in the Communication, p.2

Daniel Gros*

Reforming the Stability Pact

When large numbers of drivers ignore a speed limit, it is good practice to reconsider its rationale and, if reaffirmed, to tighten enforcement, especially if the frequency of accidents increases. Hence, the EU Commission was right in launching a debate about the Stability and Growth Pact (SGP), which has been violated by an increasing number of EMU member countries. Unfortunately, however, the Commission's proposals for reform risk watering down the Pact, resulting in an erosion of fiscal discipline. The public intervention of the German Chancellor on the pages of the Financial Times (January 17th, 2005) illustrate this danger. Continuing with the analogy of the speed limit one could say that the arguments of the head of the German government amount to saying that large well equipped cars should be allowed to drive faster.

What is being lost in this discussion is the rationale for the speed limit. Indeed, the case for a consolidation of government finances against the background of present and prospective demographic changes is if anything even stronger today then ten years ago when the SGP was designed.

The Longer-term Outlook for the European Economy and SGP Reform

The SGP was created in order to make the general prohibition of "excessive" deficits in the Maastricht Treaty operational. The Treaty, which introduced the constraints on fiscal policy, started from the assumption that nominal GDP would grow at 5% per year on trend and that a debt ratio of 60% of GDP was bearable. Consistent with these assumptions, it stipulated that government budget deficits must not exceed 3% of GDP.

In hindsight, this deficit limit appears rather generous. Reflecting the ECB's inflation target of less than 2% and real potential growth of probably only around 1¾% in Euroland, a more realistic assumption for Euroland nominal trend growth is around 3½%. To stabilise the debt ratio at 60% of GDP, the deficit would have to be capped at 2.1%. Moreover, ageing of the Euroland population raises government liabilities not included in the debt ratio in the Maastricht definition. Hence, to keep governments solvent, the latter should decline over time, ensuring that total government liabilities do not increase on trend over the next half century. These facts are generally accepted. However, neither they, nor their obvious implication that the conditions in the SGP should be tightened rather than loosened, are reflected in the Commission's Communication of 3 September 2004.

Surprisingly, the Commission seems also to have ignored a key argument in favour of tightening the threshold for invoking exceptional circumstances. With the potential growth rate having declined in most euro area countries, it is much more likely that countries will experience phases during which growth is "low" by historical standards. Hence, when potential growth is slowing, authorities need to continuously update their view about what is exceptionally "sluggish" growth. For example, a growth rate of 1.5% would most likely be considered "sluggish" by politicians when compared to the goal of 3% as agreed at the Lisbon summit. However, growth of 1.5% might already be very close to (and for some countries above) potential growth in reality, and thus not qualify as "sluggish".

The Commission Paper in Detail

In its Communication of 3 September 2004, the Commission proposed a number of reforms with the stated aim to strengthen the SGP. It starts by emphasising that more attention should be given to the evolution of public debt. This is a key point which will be addressed in more detail below because this is an area where some real progress might be achieved. But first it might be useful to consider a number of other points that are also addressed by the Commission proposal:

1. Prolonged periods of sluggish growth, which are to qualify as an "exceptional circumstance" justifying deficits of more than 3% of GDP
2. Country-specific elements in the enforcement and correction of excessive deficits
3. Country-specific elements in the definition of medium-term deficit objectives
4. Earlier actions to correct inadequate budgetary developments
5. Better links between general economic policy surveillance, fiscal policy surveillance, and national budgetary processes

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6. Improved enforcement through “early warnings” directly issued by the Commission; better fiscal statistics; greater peer pressure; greater transparency and accountability of the member states’ budgetary policies; and closer involvement of national parliaments in fiscal policy coordination

The EU’s Finance Ministers, who will decide about any formal changes to the SGP early this year, are likely to welcome the first three points of the Commission proposal for reform because they allow them to rebalance the mix of discretion and rules embedded in the Pact in favour of the former. This is likely to result in a watering down of the SGP as governments will always find excuses for an excessive deficit.

Regarding the definition of “exceptional circumstances” the Commission seems to take implicitly the stance that the raison d’être of an escape clause is to be used. Benassy-Quéré and Penot take this view even further and argue that the definition of what constitutes an exceptional circumstance contained in the SGP (a fall in GDP of 0.75%) is manifestly too tight “because this has not materialised” (since the recession of 1995).[1]

At first glance, the argument of the Commission’s paper, namely allowing a longer period of sluggish growth to qualify as an “exceptional circumstance” (granting an exception from the 3% deficit limit) seems reasonable since the accumulated output gap over several years matters more for government finances than that of a single period. The output gap could be larger after a long period of positive growth below potential than after a short recession. However, a reduction in potential growth is often recognised only after several years of weak growth. At the beginning of a period of lower growth it is difficult to decide whether this is temporary or permanent. The temptation to regard it as temporary will be impossible to resist when this has the implication that higher deficits are allowed.

Moreover, even on a purely technical basis, the experience of 2003 shows that output gap estimates are subject to large revisions as new data come in. For example, when the very low growth rate for 2003 was put in the EU Commission model for the German potential growth rate, the estimate of the output gap had to be revised downward substantially, with the consequence that the estimate of the cyclically adjusted deficit increased by almost 0.5% of GDP. Hence, points 1-2 of the Commission proposal appear to allow necessary adjustment to be delayed, creating the risk of a sizeable accumulation of excessive deficits and debt before governments recognise that potential growth has gone down.

More generally, quantifying potential growth is an extremely difficult technical judgement which leaves much room for disagreement even among experts, as one can see by looking at the differences in estimates of potential growth coming from such respected institutions as the OECD, the IMF and the ECB. If estimates of potential growth rates acquire immediate political importance, it will be extremely difficult to shield the staff of the Commission from political pressure or to prevent the Council from just coming up with higher estimates. Therefore, the need for potential GDP growth estimates in the implementation of the SGP should be minimised (although it cannot be entirely eliminated), and estimates should be carried out, if at all possible, by an independent institution.

Points 4-6 of the Commission communication constitute laudable intentions. However, the budgetary surveillance procedures proposed by the Commission lack teeth. History shows that the EU has never been able to pressure countries to consolidate government finances during good times. Hence, there is the serious risk that mostly lip service will be paid to this part of the Commission’s proposals without much tangible action.

Nevertheless, one thing may change. After the revelation that Greece has been able to systematically underreport its deficit for a number of years, it has become obvious that the capacity of the Commission to scrutinise and evaluate fiscal policy in member countries must be reinforced. As we already documented in an earlier publication,[2] the Commission cannot really supervise fiscal policy when it has only one full-time official per member country on average working in this area. Manpower is scarcer for the smaller than the larger member countries. Hence, it is not surprising that in the case of Portugal, and more recently Greece, the Commission was not able to discover large discrepancies in reported deficits. The capacity of the Commission to check national data, both ex post and ex ante, and the budget plans for the current year, must be strengthened.

These data problems – together with the monitoring problems resulting from the very large budget forecasting errors – bolster the case for the establishment of independent national budget agencies. These agencies would improve monitoring and provide alternative

[1] Agnès Benassy-Quéré, Alexis Penot: Circonstances Exceptionnelles, La Lettre Du CEPII, No. 239, Paris, November 2004.

[2] Daniel Gros, Thomas Mayer, Angel Ubide: The Nine Lives of the Stability Pact, Special Report of the CEPS Macroeconomic Policy Group, CEPS, Brussels, January 2004.

forecasts as a reality check on optimistic government assumptions.

Debts versus Deficits

One key point on which most economists agree is that the ultimate rationale for the SGP and the Treaty prohibition of excessive deficits derives from the danger that a highly indebted country might run into debt service problems. A proper SGP should make such a situation impossible. However, this implies that one should not only, or even mainly, look at deficits, but also at debt levels and their evolution. This is emphasised by the Commission Paper, which in this case is firmly grounded in the Treaty. It has by now been almost forgotten that the Treaty says that a country should be considered in excessive "deficit" (in a wider meaning of the word) also if the debt to GDP ratio is above the 60% "reference level" (Article 104c in the Maastricht version). However, the Treaty also recognises that debts constitute a stock variable that cannot be changed quickly. By contrast, deficits, which are a flow concept, can be adjusted rather quickly, but it takes time for this to have an impact on the debt level. This is recognised by the Treaty which says that an "excessive debt" is not a problem if "... the [debt/GDP] ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace."

Unfortunately, the meaning of what constitutes "approaching at a satisfactory pace" the 60% reference level for debt has never been officially clarified. However, this uncertainty could actually be resolved on the basis of the numbers contained in the Treaty, combined with some standard debt – deficit arithmetic.

Recall that the underlying assumption in the Treaty, which renders the 3% deficit consistent with the 60% debt level, is nominal growth of 5% of GDP. Under this assumption it is straightforward to show that a country that observes the 3% deficit limit should under ordinary circumstances see its debt to GDP ratio declining automatically towards the 60% target. If the deficit is equal to 3% of GDP the speed of this convergence towards the target would be slow as only 5% of the difference between the actual debt/GDP ratio and the 60% target would be eliminated each year. But this rule would at least ensure a minimum of convergence and a country that starts with a higher debt level would automatically achieve larger reductions in the debt/GDP ratio. A country that starts with debt equal to 120% of GDP and has a deficit of 3% would "automatically" achieve a reduction in the debt ratio of 3 percentage points; a country that starts with a debt burden of 90% of GDP would get only 1.5 percentage points.

Table 1
Evolution of Debt Levels

	Debt/GDP Ratio 2000	Debt/GDP Ratio 2003	Reduction in debt ratio?	Compliance with debt rule?
Belgium	109.1	100.0	Yes	Yes
Italy	111.2	106.2	Yes	No
Greece	114.0	109.9	Yes	No
France	56.8	63.7	No	No
Germany	60.2	64.2	No	No

Source: AMECO. The data for Greece are obviously subject ro revisions.

In order to ensure that the improvement is not transitory it would be necessary to check whether this criterion has been met over a number of years before the examination. The following rule would achieve this:

The debt to GDP ratio is considered "approaching the reference value at a satisfactory pace" if, over the previous three years, it has been declining continuously and, on average, one twentieth of the difference between the initial debt ratio and the reference value of 60% of GDP has been eliminated each year.[3]

This rule should be applied each year when the public finances of member countries are examined for the excessive deficit procedure. At first sight it seems that it would be relevant only for those member countries that have a debt/GDP ratio that is clearly above the 60% reference value (Belgium, Greece and Italy). But it would also catch countries like Germany and France, whose debt levels are close to the 60 % threshold, but have gone up considerably over the last years (in the case of Germany from close to 60 % as recently as 2001 to 67% of GDP now and probably close to 70% in 2006).

Table 1 shows the evolution of the debt levels of the high debtors (Belgium, Italy and Greece) plus that of the two worst offenders against the SGP (France and Germany). This data shows clearly that only one of the three high debt countries (Belgium) has achieved the reduction in debt levels that one could consider conforming to Maastricht. For France and Germany it is clear that the trend is unsustainable. If France and Germany were to continue to accumulate debt as they have done over the last three years they would end up with debt/GDP ratios not far from the levels of the three high debtors today.

This strong increase in the German and French debt to GDP ratios despite deficits that were not that far above 3% of GDP is just a manifestation of the general

[3] Daniel Gros: Excessive Deficits and Debts, CEPS Working Document No. 97, Brussels, October 1995.

argument made in the introduction: with lower growth even a 3% deficit can lead to unsustainable debt accumulation. Taking into account the evolution of the debt would reinforce in cases like France and Germany the case for a strict application of the excessive deficit procedure by looking not only at deficits, but also the evolution of debt.

Policy Conclusions

The SGP was designed so that countries would be able to let automatic stabilisers work fully. For that, countries were required to achieve as soon as possible the desired starting point, namely a budget close to balance or in small surplus. The design of the SGP would then allow countries to weather cyclical fluctuations while respecting the 3% limit. This background is important for understanding the SGP fiasco, and it is essential to understand why the situation now is even worse than it was at the beginning of EMU.

Why did some countries breach the 3% limit? Because they did not meet the commitment to achieve a budget position close to balance or in small surplus before the cyclical downturn of 2001-03. The real problem was thus not that the SGP parameters were inadequate. The failure was due to domestic fiscal policy decisions, not to the SGP parameters.

Today the situation is the even worse. There are two groups of countries: those which have the required budgetary starting condition of close to balance or small surplus, and those which do not. A re-parameterisation of the SGP by giving more emphasis to the evolution of debt (not only its level) might be desirable as argued above. But even the most thoughtful reforms are going to fail for the countries that do not meet the initial requirement. If the European fiscal policy framework is to regain any credibility, it must ensure that the "sinners" behave better this time. Peer pressure for greater fiscal discipline has proven ineffective. Hence, the sinners must be required to publish detailed plans how they intend to achieve the desired initial budgetary conditions as soon as feasible. They must demonstrate ownership of these plans by investing political capital in them, for example by committing before their own parliaments to a rigorous three-year plan approved by the Commission and to report back any deviation before their parliaments. This procedure is a model used by the IMF for programmes that have gone off-track: in this case, the authorities must make additional efforts to put the programme back on track.

Current prospects are not encouraging: the French plan to reduce the budget deficit to 2.9% in 2005 is almost entirely dependent on a transfer of 0.5% of GDP from the energy utilities in return for assuming pension liabilities. Not only does this worsen the long-term fiscal outlook, but it is a reminder of how France only managed to meet the Maastricht criteria via another one-off transfer – that time from France Telecom. Fiscal adjustment plans for Germany and Italy presently also lack the necessary rigor to achieve lasting reductions in deficits.

If the sinners do not make the extra effort, the SGP will become an empty shell and debt levels will continue to increase. It is maintenance work rather than a new SGP that is needed. It is up to the Eurogroup to decide. But this may be the last chance to take forceful action against the sinners before the demographic shock starts hitting and debt levels start to accelerate towards unsustainable levels.

Carsten Hefeker*

Will a Revised Stability Pact Improve Fiscal Policy in Europe?

Bowing to pressures from member states the European Commission has decided to propose a revision of the rules of the Stability and Growth Pact (SGP). Commissioner Joaquin Almunia has presented a proposal, which was discussed recently by the representatives of the member states.[1] There is no doubt that a considerable relaxation of obligations will result. In the end, the rules for fining violators of the 3 per cent deficit rule will be much less binding than originally laid down in the SGP.

The proposal by the Commission will increase tremendously the flexibility to judge and decide on pos-

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sible sanctions against those countries failing to fulfil the SGP. Currently the Commission advises ECOFIN, the member states' ministers of finance and economics, that a country should be held to be in violation of the 3 per cent deficit rule, a rule that was originally conceived as an entry condition for membership of the monetary union. It was later extended to countries that are already members of the EMU. Despite the apparently clear conditions under which the rules of the SGP have to be applied, ECOFIN can decide not to follow the Commission's proposal.[2]

The Commission has apparently realised that it cannot win against ECOFIN and has therefore decided that it is unable to enforce the SGP against the will of the majority of member states. While Almunia's predecessor, Solbes, tried to fight against member states, Almunia has acknowledged the obvious and has given in to the pressure. His proposal allows for a wide range of reasons why a country is in violation of the 3 per cent rule but will not be held responsible. The Commission will still point out the violation to ECOFIN but then those reasons can be put forward by the member state concerned to explain why it should not be held liable for its breach of the SGP.

Almunia's proposal is a general reorientation of the pact, no longer focusing so much on the 3 per cent rule but placing more weight on medium-term debt sustainability. Countries with a generally healthy fiscal situation and close to meeting acceptable levels of overall debt would be allowed to run larger deficits.[3] Also, countries with low growth rates for an extended period would be allowed to violate the 3 per cent rule, as would countries that have higher deficits because they pursue growth friendly investment projects. Implementing structural reforms that result in higher growth and lower deficits further down the road would also lead to a temporary exemption. The Commission's role would be to control for all those special factors, incidentally also increasing the power of the Commission. Should the Commission not accept the reasons brought forward by the member state and demand corrections to its fiscal course, it is hoped that the increased economic sense of the rules would result in a greater acceptability of the Commission's decision. It has thus been recognised that one significant problem under the current SGP is that there is only little rationality for the arbitrary 3 per cent rule. Presently, member states often can, and do, claim that the Commission's position makes no economic sense.[4]

In addition to the Commission's proposal, member states have been quick to formulate their own wishes for revision, basically extending the list of exceptions that the Commission proposed. It has been suggested that net payments to the EU budget should not be counted among the 3 per cent, benefiting the net-payers to the budget by deducting their contributions to the poorer member states. France would also like to see exceptions for defence expenditures and Germany for having to support the development of east Germany. The German government also suggested that the relative impact of a deficit on the rate of inflation should be taken into account. Since the SGP was designed to accompany the monetary union, this would at least be consistent with the once formulated idea that fiscal rules are necessary to defend the integrity of monetary union and the European Central Bank's independence.[5] If all these wishes were to be accepted, not much would remain of the SGP, letting the dreams of some ministers of finance come true who would like to scrap the SGP altogether but do not dare to say so frankly.

Unfortunately for Germany and other large members, the recent meeting of heads of state and ministers of finance at which these issues were discussed has not come around to helping to make those dreams come true. The meeting, although not having reached a formal decision, accepted a significant increase in the flexibility of the SGP, but this was not as wide-ranging as some would have liked. There is apparently no consensus that whole spending items should be deducted from the budget completely, such as expenditures for research and education, nor will defence spending and net contributions to the budget automatically be deducted. Hardliners like the Netherlands and Austria were obviously not willing to go along with

[1] Cf. Communication from the Commission to the Council and the European Government: Strengthening Economic Governance and Clarifying the Implementation of the Stability and Growth Pact, COM (2004) 581, September 2004.

[2] Under the SGP countries are only exempted from fulfilling the 3 per cent deficit criteria if their GDP declines by more than 2 per cent in a given year. A decline of less than 0.75 per cent does not allow exemption, while it is in ECOFIN's discretion to decide for figures in between. Clearly, deciding not to open the excessive deficit procedure for countries without a decline of more than 0.75 per cent should not be possible, but according to the European Court of Justice this nevertheless falls under the discretion of ECOFIN.

[3] Therefore the revision would bring in the second fiscal criteria for membership in EMU: the rule that the debt stock should be no more than 60 per cent of a country's GDP. This played no role in the SGP original formulation.

[4] Of course, member states agreed on the 3 per cent in the first place. It is therefore less than convincing to question the sense of the rule now.

[5] It is therefore no surprise that the ECB and individual central banks have come out strongly in defence of the unreformed SGP.

the idea of automatic exclusion of whole spending categories.

Moreover, the carrot of a more flexible interpretation of deficit figures comes with the stick of enforcing the member states' obligation for a consolidation in better times. Automatic stabilisers should work not only in business cycle troughs but also in economic booms, although this objective is not accompanied by numerical specifications or the threat of sanctions. The Commission's idea of putting more weight on the overall debt stock did not meet with support from the member states, so that this criterion will not become as important as deficits in the assessment of member states' fiscal performance.

Despite the fact that not all member states wanted to go along with all the relaxations, there seems to be general consensus that certain expenditures should be allowed to come on top of the 3 per cent deficit. This actually turns the SGP on its head. The underlying goal of the SGP was to require countries to run a near to balanced budget in normal times. If countries really did this, most of them could easily keep within the borders of the 3 per cent deficit allowed to finance all those extra things which they now would like to see deducted from the 3 per cent, and to let automatic stabilisers work in recessions or periods of slow growth. Instead, most of the statements by officials in member countries, in particular in Germany, neglect this small but not completely irrelevant fact. They tend to create the impression that a deficit of 3 per cent should be aimed at and that more leeway would be justified if negative shocks hit or structural problems cannot be addressed.

The Commission, of course, is aware of this contradiction, which is why the substantial relaxation of the rules should be accompanied by positive budget balances and a reduction of the debt stock in good times. The problem with the SGP's philosophy of keeping countries close to balance in good times is that there is no lever to force countries to do this. In fact, the major "sinners" among the member states have run a largely pro-cyclical debt policy instead. This is why incentives to care for leaner times in fat times should rightly be increased.

The Logic of Fiscal Rules

Whether the revision proposed by the Commission, or what member states make of it, is sensible and will help to improve fiscal policy in Europe is an open question. The answer depends very much on what the purpose of the SGP has been and how the revised version of the SGP addresses these concerns.

There are basically three reasons why it might be wished to constrain the fiscal policy of members in a monetary union. The argument most often used in the run-up to monetary union was that an expansive monetary policy could ultimately lead to pressures on the common central bank to run a more expansive monetary policy. This could take the form of direct pressure on the central bank to monetise the governments' budgets by buying up government bonds in the secondary market (the central bank is not allowed to buy those papers directly from the government). A possible alternative is that the expansive fiscal policy puts upward pressure on the level of interest rates and that the central bank would aim to counter the negative implications by accommodating monetary policy. In both cases it is feared that this policy would result in higher rates of inflation, hurting all member states in the union and not only those pursuing such a fiscal policy.

The second argument is based on the fact that an expansive fiscal policy pushes up the common level of interest rates. In a common financial market the increased demand for funds raises the price of credits union-wide. This increased demand will drive up the price for all governments, including those with a frugal fiscal policy. To avoid these pecuniary spillovers, the possibility of running such a fiscal policy should be constrained by common rules.

A fundamental assumption behind both arguments is that governments do not internalise the externalities created by their behaviour. In fact, knowing that they are only a small part of the union, individual countries could hope to get away with such a policy without having to bear the full costs of their fiscal behaviour.

Finally, the third argument is that the SGP is not really necessary because of EMU, but because governments have come to realise there is a fundamental deficit bias in fiscal policy. Because of the short-term horizon of politics, and because governments have a tendency to be generous before elections without being willing to increase taxes after elections, fiscal policy has a tendency to be too expansive. Experiences with the massive debt increases in Europe in the 1970s and 1980s at least support this view. Having recognised this general negative trend, governments might look for a way to commit themselves credibly and to use the SGP as a mechanism to force themselves (and their successors in office) to run a more responsible fiscal policy.

Arguments concerning the externalities of fiscal policy apply especially to the larger states. Externali-

ties will obviously be felt most strongly by them. If a very small country like Luxembourg ran an excessive deficit the result would be very different from that of Germany's running a deficit. In other words, it would be most appropriate if particularly large states were forced to comply with the SGP rule because smaller states do not impose strong negative externalities on their neighbours. In fact, however, the opposite is the case. Germany is not forced to play by the rules, but Portugal has been officially warned of an excessive deficit, and it is in the case of Greece that it has been decided (with the vote of Greece) to go ahead with the deficit procedure, most likely ending up with a fine. In contrast, the fiscal policies of Germany, France and Italy are treated generously. Member states seem to be prepared to let the big guys get away with things the little ones would never be allowed to do.

There are several possible reasons why the EU treats large members differently from small members.[6] One argument is that the costs of fiscal retrenchment in larger countries are larger and that they therefore resist fiscal retrenchment more. Because smaller countries are more open, demand oriented policies work less, forcing them to focus more on supply-side policies. If that is the case, it makes sense to let the larger countries run larger deficits because the costs to them of restrictive fiscal policies are higher. On the other hand, any deflationary impact of restrictive fiscal policy is likely to be more strongly supported by the ECB if a large country is concerned.

A second argument is that fiscal consolidation is easier to achieve with strong growth. Because especially the larger member states have dismal growth rates, consolidation is less easy. While this is probably true from a political-economic point of view, not only fast growing countries have been able to put their fiscal houses in order. In any case, given that estimates for trend growth in Europe have been revised to lower levels than in earlier decades, there is no excuse to postpone necessary structural adjustments even further. In fact, the reason for slow growth has very likely also to do with "too little too late" structural reforms in the larger member states.

The third argument is that the larger states are more powerful politically and that they therefore have a higher probability of not being fined. Large countries are less likely to suffer as much in terms of lost reputation for breaking the rules than small ones. Moreover, the larger countries carry a larger weight in the Council decisions and can therefore hope to get away with a breach of the rules. Finally, it might also play a role that the smaller states themselves are not very interested in forcing a fiscal consolidation on the larger states for fear of negative spillovers from a recession.

Does a Revision Address the Crucial Points?

Noting the possible reasons for the SGP in the first place, and why the larger states have apparently more problems in fulfilling those rules, the question is, how would a revision of the pact address the underlying problems? Would a revision help to achieve the objectives of the pact better?

The apparent aim of the Commission's proposal is to avoid fiscal policy spillovers on monetary policy. Making this the main objective of the SGP, however, entails the problem that there is no visible relation between monetary and fiscal policy at the moment. Of course, one never knows whether the ECB will eventually be pressured to relax monetary policy in order to bail out fiscal policy. But at the moment this danger is not visible. The ECB seems well positioned to reject any indecent proposal to relax monetary policy. Attempts to pressure the bank will likely only lead to its being even more restrictive, as experiences in recent years have shown.

Also, the argument that a reckless fiscal policy will push up union-wide interest rates and therefore hurt those countries which are running a more responsible fiscal policy is not convincing. The EU is part of a worldwide integrated capital market. That any single country, even a big one, can move interest rates to a significant extent is rather unlikely. More important, capital markets have proven to be well able to distinguish among different sovereign borrowers. Those running large deficits should be forced to pay adequate risk premiums as a function of the sovereign's fiscal position. Countries deemed close to insolvency, or that have at least a higher risk of insolvency, should pay higher premiums than countries with a more favourable fiscal position. The US example at least suggests that financial markets are well able and willing to demand state-specific risk premiums if that is deemed adequate.[7] While it is true that at the moment financial markets do not require hugely different interest rates from sovereigns in the EU, this does not imply that

[6] Cf. Marco Buti, Lucio Pench: Why Do Large Countries Flout the Stability Pact? And What Can Be Done About It?, in: Journal of Common Market Studies, Vol. 42, 2004, pp. 1025-1032.

[7] For evidence concerning the USA and Europe, cf. Kerstin Bernoth, Jürgen von Hagen, Ludger Schuknecht: Sovereign Risk Premia in the European Government Bond Market, ECB Working Paper 369, June 2004.

they expect bailouts among member states. It only means that the risk that any one state will fail to pay its obligation is deemed rather small.

Which leaves us with the third option, namely that the SGP is in the well understood interest of single states and that they use the external mechanism to overcome their own time-consistency problem in fiscal policy.[8] Governments have a tendency to run fiscal deficits in order to avoid the short-term political costs of fiscal consolidation. A time-horizon of only four years might tempt governments to use fiscal debt rather than making hard decisions and putting fiscal cuts in place. Although many governments have realised that fiscal consolidation will ultimately pay off, and although even voters increasingly seem to favour fiscal frugality, the tendency to run deficits persists in some member states. As argued above, this is particularly true of large countries, where social and other structural reforms are harder to implement because large countries are less exposed to international influences and thus there is less awareness of the need for adaptation. The SGP could be a welcome instrument to solve this problem and to use the external constraint to put relevant rules in place at the national level as well. Unfortunately, most of that incentive, if it ever existed, seems to have disappeared. At the moment, the larger states do not seem to view the SGP as a chance but only as a burden.

The proposal by Almunia and the likely revision of the pact resulting from further discussion does not tackle this fundamental problem but looks almost exclusively at the monetary-fiscal policy conflict. Accordingly, it also misses the main problem of the longer term consequences of the larger countries' fiscal policies. It is true that is also wants to put more emphasis on debt rather than deficits, which is sensible in itself, but it still considers fiscal policy and reforms in the area as a short to medium run problem, while in fact it is a long-run problem given the demographic changes in Europe.[9]

Estimates of implicit public debt in EU member states confirm that especially the larger European countries face a demographic crisis.[10] This has implications for the current debate. While the standard argument about inter-temporal tax policy is usually that future generations do profit from current investments and that it is therefore appropriate to let them share in the costs of those investments, the argument is not convincing in the current context. The golden rule that investment could be financed through debt is turned on its head in today's situation. In fact, current generations are living at the costs of future generations. Not only do they want them to share in the costs of investments but they also want them to carry the burden of financing retirements. In fact, by far the biggest item in governments' fiscal position today is the implicit obligation to finance pensions and retirements.

Given a shrinking population, intergenerational justice requires current generations to save now and to share in the costs of financing their own retirements. The golden rule, currently much cited by finance ministers, would thus probably mean that even more should be saved and that debt should in fact be negative, given that the implicit debt stock is already two to three times higher than the official debt stock in many EU member states.

The Commission's proposal does not do enough by far to stress this point. While it rightly proposes that government debt should play a prominent role in future decisions about deficits and possible obligations to revise policies, the full extent of the demographic problem is not addressed. Maybe this is because Almunia has realised he has no chance of convincing member states. But the confrontational strategy of his predecessor Solbes at least called attention to the underlying problems, even at the price of losing possible power struggles with member states. It is understandable that the Commission does not want to repeat such experiences. But becoming an accomplice to the member states' policy by not pointing out the gaps in the member states' policies is worse. In fact, the impression is that the Commission is itself proposing ways to make the pact even more irrelevant and to officially sanction the way it has been violated and mutilated by member states. Instead of naming the underlying problems and looking for ways to address them, there seems to be a coalition between the Commission and larger member states to postpone the necessary structural adjustments for as long as possible. This does not augur well for the future of fiscal policy in Europe.

[8] For a description and discussion of the problem, cf. Allan Drazen: Political Economy in Macroeconomics, Princeton University Press 2000.

[9] Moreover, as described above, member states are not likely to go along with this particular item of the proposed revision.

[10] Cf. Economic Policy Committee: Budgetary Challenges Posed by Ageing Populations, Brussels, October 2001 (EPC/ECFIN/655/01-EN final).