

The Stability and Growth Pact - An Analysis of the Pros and Cons

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Contents

List of Figures	iii
List of Tables	iii
List of Abbreviations	iv
1 Introduction	1
2 Origin of the SGP	2
2.1 Fiscal situation in the early 1990s	2
2.2 Considerations on the rationale of sound fiscal policies	3
2.3 German initiative	4
2.4 Negotiations on the Pact	6
2.5 The Consensus on the Stability and Growth Pact	6
3 Provisions of the SGP	6
3.1 Prevention: the Regulation on Surveillance	7
3.2 Dissuasion: the Regulation on Excessive Deficits	8
3.2.1 Assessment of an excessive deficit position	8
3.2.2 Deadlines for the steps of an EDP	9
3.2.3 Application of sanctions	10
4 The implementation of the SGP: the first five years	11
4.1 Budgetary performance in EMU	11
4.2 Role of the EMU fiscal framework in influencing national budgetary choices	14
4.3 Implementation at national level	15
4.3.1 German national stability pact	17
4.4 Enforcement mechanisms at work	19
4.4.1 Early warning to Germany	19
4.4.2 EDP against Germany	20
4.5 Lessons drawn	22
5 Improvement of the budgetary surveillance framework	24
5.1 The appropriate medium-term budget target	25
5.2 Taking account of the economic cycle	28
5.3 The sustainability of public finances	30
5.4 Public investment and the EMU's budgetary framework	35
5.5 Aggregate fiscal stance as a target	39
5.6 Conclusion	40

6	The debate on the conduct of fiscal policy in EMU	40
6.1	Active use of fiscal policy versus automatic stabilisation	41
6.1.1	The effectiveness of discretionary fiscal policy in EMU	43
6.1.2	The effectiveness of automatic stabilisation in EMU	44
6.1.3	Political impediment against automatic stabilisation	46
6.2	Asymmetric work of the SGP	47
6.3	Conclusion	48
7	Further strengthening of the SGP	49
7.1	Recent efforts to improve the interpretation of the SGP	49
7.2	Alternative reform suggestions	51
8	Conclusion	52
	List of references	56
	Appendix 1: Figures	62
	Appendix 2: Tables	67

Figures

1	General government: expenditure, revenues and borrowing in the EU, 1970-1997	62
2	The Stability and Growth Pact: prevention and deterrence	62
3	Changes in the average euro-area CAPB and the euro-area output gap in 1992-2003	63
4	Euro-area GDP in absence of fiscal discipline, simulation with the Commission QUEST model (% change of GDP compared with baseline)	63
5	Budget deficits and procedures launched by the Commission and the Council concerning 6 euro-area countries, 2000 – 2004	64
6	Budgetary consolidation in Germany 1999-2006, as assessed in 2002	64
7	Projected debt developments for fourteen EU member states (excluding Austria) based on compliance with the targets for 2006 set down in 2002 stability and convergence programmes	65
8	Public investment changes in the 1990s (average yearly growth rate in gross fixed capital formation, general government, % of GDP at current market prices)	66
9	Interest expenditure and public investment, EU-15, 1970-2002	66

Tables

1	Economic indicators in the European Union in 1995 and the Maastricht Treaty convergence criteria (excluding the exchange rate criterion)	67
2	Budgetary developments in 1999 (% of GDP)	67
3	Budgetary developments in 2000 (¹) (% of GDP)	68
4	Euro-area budget deficits in 2000-2003, excluding UMTS proceeds (% of GDP)	68
5	Government debt ratio in EMU member states, 2002-2005 (% of GDP)	68
6	Budget balances in EMU member states, 2000-2004 (% of GDP)	69
7	Estimates of cyclical safety margins and minimal benchmarks, 2002	69
8	Long-term debt to GDP ratio in EU-15 up to 2050	70
9	A schematic representation of the proposals for reform of EU fiscal policy-making	70

Abbreviations

BEPG	=	Broad Economic Policy Guidelines
CAB	=	cyclically-adjusted balance
CAPB	=	cyclically-adjusted primary balance
ECB	=	European Central Bank
ECOFIN	=	Economic and Financial Council
EDP	=	Excessive Deficit Procedure
EEO	=	European Economic Outlook
EMI	=	European Monetary Institute
EPC	=	Economic Policy Committee
FPC	=	Financial Planning Council
HP	=	Hodrick-Prescott
PF	=	production function
p.p.	=	percentage points
SGP	=	Stability and Growth Pact
TEC	=	Treaty on European Community
The Treaty	=	the Maastricht treaty

1 Introduction

The Stability and Growth Pact (SGP) has attracted much attention since the idea was first suggested by German Finance Minister, Mr. Waigel, in late 1995. Naturally, there is not an unanimous view on the Pact: for some it is an unnecessary restriction; for others the Pact is necessary but requires further development and strengthening; finally there are those who consider that the SGP sets wrong objectives and, thus, while fiscal rules are necessary, must be replaced by some other arrangements. The discussion on the rationale of fiscal rules in a monetary union goes beyond this work. That is, the analysis in this work will be built upon the general consensus on the necessity of fiscal restrictions in the context of a multinational unification with the common currency. In the focus of the work stands the design of the Pact. Unanimously adopted in December 1996, the rules of the SGP caused substantial doubts already several years later. The first violations of the Pact took place already in the third year of its operation. The most astonishing is the fact that the country, which was the initiator of the Pact, has violated it among the first ones and called its credibility into question. This has led to intensive debates on the numeral rules of the Pact and its implementation which is said to be inadequate. Whence, the purpose of this work is to trace the operation of the SGP starting with its introduction and up to today, with the objective to find out what have caused the breach of the rules. The work attempts to answer the question, whether the SGP has properly fulfilled its role, that is, whether it proved to be an efficient mechanism for enforcing fiscal discipline.

Aiming to provide a thorough and impartial answer to the posed question, the approach of detailed investigation of diverse studies and points of view is chosen in this work. When assessing the recent developments in the euro-area, the publications of the European Commission are chosen as probably most independent source of information. However, also the data stemming from the Commission is confronted with other views and studies. It is important to note that the results of the following investigation do not claim to give a precise answer to a question, but rather are a useful lead for further studies and debates.

The work is organised as follows. In order to lay a good foundation for an assessment of the events around the SGP, the origin and the incentives to adopt the Pact are recalled in chapter 2. The description of the final version of the SGP in chapter 3 gives an insight into its structure, procedures and objectives. Having gained fundamental understanding on the backgrounds of the SGP, one can proceed to the assessment of the operation of the Pact. How have member states implemented the SGP and performed in

its context? Had the new fiscal framework any influence on their budgetary choices? Have the enforcement mechanisms of the Pact properly functioned? Investigation of these questions, presented in chapter 4, reveals a number of shortcomings both in the rules of the Pact and in its implementation. However, the experience gained during the operation of the SGP has showed the possible directions for its further strengthening. The debate on the budgetary surveillance framework and its development are assessed in chapter 5. The issues concerning the conduct of fiscal policy in EMU are discussed in chapter 6. Chapter 7 introduces two courses of further possible development of the Pact: the first one, chosen by the EU institutions, and the other one, suggested by diverse academicians and policy-makers; with the objective to assess merits and disadvantages of both. Final considerations and conclusions are presented in chapter 8, supplemented by several recommendations on further treatment of the subject, which are based on the investigation carried out in the work.

2 Origin of the SGP

2.1 Fiscal situation in the early 1990s

Up to and including the early 1990s widening general government deficits and a corresponding rise in government debt could be observed in many countries. Almost without exception, the average general government deficit in the EU as a whole was above 3% of GDP from 1975 onwards, attaining a historical high of 6% of GDP in 1993 (Figure 1 in the Appendix 1¹). High and persistent deficits led to rapidly increasing levels of government debt. The EU aggregate debt to GDP ratio increased from less than 30% in the late 1970s to a peak of 72% in 1996. The reasons for this were mostly of domestic nature. Countries had lax spending habits even during long periods of sustained economic weakness, and they had misguided employment policies. In addition, there was the burden of demographic trends on social security systems. These hardenings of financial structures were reflected in structural deficits that were difficult to reduce².

Up to summer 1995 the implementation of the convergence criteria of the Maastricht Treaty was not satisfactory in every respect. A 1995 review by the Monetary Committee drew attention to shortcomings with the convergence programmes. Member states attached little prominence to these and their content was unsatisfactory. Moreover, they lacked ambition as the medium-term budgetary objective, and the Council had real difficulties in getting member states to adjust their programmes to address weak points. The degree of convergence attained in 1995

¹ All Figures are gathered in the Appendix 1, p. 62.

² See Stark 2001, 79.

suggested a mixed picture (Table 1 in the Appendix 2³). Whereas eleven of the fifteen EU countries were within acceptable distance from the price stability and interest rate differential criteria, the fiscal positions of the public sector told a completely different story. Figures for 1995 show that only Denmark and Ireland achieved a deficit of below 3% of GDP, while Luxembourg registered a surplus. In eleven EU countries deficits in 1996 were still projected to stand at above 3% of GDP and continue to be a cause of great concern. Most countries had not yet achieved a situation which, in a broader view, might have been judged as sustainable in the medium-term, as it is clearly seen in worrisome debt positions (EMI 1996). These poor economic developments gave an impulse for additional efforts to accelerate the Europe-wide consolidation of public finances.

2.2 Considerations on the rationale of sound fiscal policies

The idea of a stability pact had already been informally floated by the German authorities in autumn 1995. The rationale behind this idea was to prevent the monetary policy of the future European Central Bank from being undermined by unsound fiscal policy practices of participating countries and to prevent the ECB from having to assume the burden of guaranteeing price stability alone. It was also intended to send a convincing signal that budgetary discipline was not just one of accession criteria to be met only at the start of Stage 3 of the EMU, but that all member states would maintain sustained and lasting budgetary discipline even after the decision on their entrance into Stage 3. This would strengthen the confidence of the public and the market in the stability orientation of the EMU (Stark 2001, 83).

It is indisputable that unsound fiscal policy practices have adverse effects on price stability, growth and employment. On the other hand, budgetary discipline ensures a stable macroeconomic environment and thus enhances potential growth and employment. Governments contribute directly to growth and employment, for example, by enhancing factor accumulation. Investment in physical (infrastructures), human (education and training) and knowledge (R&D and innovation) capital, and, to a lesser extent, social spending, affect long-run output and growth potential. However, if higher public investment is financed through a rise in distortionary taxes or if it increases deficits and consequently public debt, it may crowd-out private investment. In addition, tax and benefit systems affect the functioning of the real economy by influencing people's and businesses' decisions on work, saving and investment. Efficient social protection can be viewed as a 'productive' factor. However, it is necessary to ensure that tax and benefit systems are conducive to higher participation and employment rates. Budgetary discipline ensures a stable macroeconomic environment and thus

³ All Tables are gathered in the Appendix 2, p. 67.

impacts growth and employment via a number of direct and indirect channels. As regards direct channels, sound public finances support monetary policy in maintaining stable prices and result in lower interest rates. This can enhance private investment, leading to higher growth of the capital stock in the medium- and long-run. Secondly, the running down of public debt lowers the interest burden, providing room for reducing distortionary taxes and/or an increase in productive public spending. These both actions can facilitate factor accumulation. A further direct channel is via aggregate savings, which is the sum of private and public saving. To the extent that increased public saving raises aggregate national saving, additional resources may become available for productive investment. Budgetary discipline also indirectly affects growth and employment by contributing to macroeconomic stability. First, it may foster stable inflationary expectations, thereby reducing uncertainties and improving predictability for savers and investors to plan for the long-run. Second, budgetary discipline ensures that governments can allow the automatic fiscal stabilisers to operate fully in the face of economic downturns thereby smoothing the business cycle. Finally, achieving balanced public finances today can help countries cope with the long-term budgetary challenge posed by ageing populations. Lower levels of public debt reduce the interest burden and thus partially offset increased public expenditures on pensions and health care. A failure to place public finances on a sound financial footing to cope with ageing populations, may lead to unsustainable high tax rates in the future which can hamper growth and job creation (Commission 2000, 14). These considerations on the repercussions of fiscal policy are especially important for a monetary union because of the danger posed by negative external effects, which increases with ongoing economic integration. There might be adverse consequences for all the other participating countries from the unsound policy of a single country, which are transmitted through three basic channels: intra-EMU trade flows, area-wide interest rates, and the common exchange rate.

2.3 German initiative

For the first time the German Federal Ministry of Finance expressed its interest in additional government budget provisions for states participating in Stage 3 of the EMU in London at a conference held by the US investment bank Goldman Sachs in May 1995. It was argued that the participating states should agree among themselves to establish additional commitments and regulations that would ensure the adoption of sound fiscal policy practices in Stage 3. The European economic and monetary union must be protected against the unsound fiscal policies of individual member states. At the same time it was emphasised that the underlying intention was neither to postpone the

start of monetary union nor to add another criterion for entry. The main concern here was that countries after accession to monetary union might fall back into their old routines in the absence of any binding budget rules and sanctions. The German Federal Bank pointed out that only introduction of additional regulations could ease the potential conflict between a single monetary policy and decentralised fiscal policies without making member countries lose their national jurisdiction over government budgets. The principle of subsidiarity would thus be safeguarded. At that stage the proposed agreement was familiar under the name 'fiscal policy Schengen agreement'.

Germany sketched the most important requirements during the meeting of the ECOFIN Council in Brussels on 18 September 1995. These included, first of all, more restrictive budgetary targets which should ensure that the deficit ceiling of 3% of GDP is not violated during any stage of the business cycle, and stringent, automatic sanctions if the rules are violated. The initial reactions to the German proposals were characterised by a certain reserve, especially in the case of the larger member states. The German Federal Minister of Finance, Mr. Waigel, could however ease the situation pointing out again that only if the fiscal policies of the member states were fundamentally sound, the advantages of monetary union could be fully exploited and unnecessary tensions with lasting and adverse consequences for growth and employment be avoided. During the informal ECOFIN meeting in Valencia, September 1995, the participants acknowledged the need to establish regulations that would guarantee price stability for the following 'generations of finance ministers' (Stark 2001, 83).

In response to that acknowledgement the Federal Ministry of Finance prepared a draft of the rules, which the member states were expected to follow. That included four parts. First, budgetary discipline regulations which defined the restriction on the growth rates for government expenditure to be held below the increase in nominal GDP over the medium term, set up the 3% ceiling on deficits in all business cycles with the exceptions only in extreme cases and only after approval of a qualified majority of the member states, and prescribed the stock of government debt to be consistently reduced. Second, establishment of an early-warning system within which the compliance with the rules is to be monitored in the spring and autumn of every year. Third, mechanism for the automatic imposition of sanctions with the emphasis on 'automatic'. If a member state exceeds the deficit ceiling the following sanctions mechanism is to be automatically activated. The member state concerned must make a non-interest-bearing deposit of 0,25% of its GDP for each whole percentage point in excess of the deficit ceiling. This deposit will be repaid if the deficit falls back below the prescribed ceiling. If after two

years the deficit ceiling is still being exceeded the deposit will be converted into a fine. Fourth, formation of a European Stability Council within the ECOFIN Council which examines the national budget stances and decides on whether the budgetary discipline rules have been violated and, if necessary, enforces them. In extreme cases it also decides on whether an exemption from the deficit ceiling rule is to be granted.

2.4 Negotiations on the Pact

The detailed proposals of the Federal Ministry of Finance were sent to the ECOFIN on 10 November 1995. While the general objectives of the German proposal found widespread support, a number of specific issues and problems had been raised. Among the economic problems, there were questions of an appropriate medium-term target for budget positions and how strict it must be. Some alternatives under consideration included a differentiating medium-term target according to country, an aggregate fiscal stance target for the entire European Union, and a target value for the stock of the government debt. There were also lasting debates on the Excessive Deficit Procedure (EDP). The questions raised here concerned among all the definition of ‘effective actions’ to combat deficits, appropriate sanctions and their automaticity, and the determination of exceptional circumstances, especially the question of what was to be understood under ‘severe recession’. One of the important legal issues to be clarified was the basis for the Stability Pact, that is, the legal base for its preventive and dissuasive elements (Stark 2001, 91). Central argumentation-lines on these issues, both pro and contra, can be found in the subsequent chapters, as they reappear in the current debates.

2.5 The Consensus on the Stability and Growth Pact

The consensus on the Stability and Growth Pact was reached during the European Council meeting in Dublin, December 1996. The implementation of the Pact followed in Amsterdam in June 1997 in the form of two Regulations and a Council Resolution. Entrance into force was carried out in two steps: on 1 July 1998 – the surveillance part, and on 1 January 1999 – the dissuasive part, thus making the SGP fully applicable. The provisions of the final version of the SGP are introduced in the next chapter.

3 Provisions of the SGP

The SGP is adopted to strengthen the Treaty provisions on fiscal discipline in EMU foreseen by articles 99 and 104 of the Treaty. The resulting pact went far beyond the original German proposal. As presented on Figure 2, it is constituted by two Council Regulations and a Resolution of the European Council. The first Regulation, „on the strengthening of surveillance of budgetary positions and the surveillance and co-

ordination of economic policies⁴⁴, deals with the preventive dimension of the SGP. The second Regulation, „on speeding up and clarifying the implementation of the excessive deficit procedure⁴⁵, deals with the dissuasive part of the SGP. The Resolution of the European Council provides political guidance to the parties who will implement the SGP (the Commission, member states, the Council) and contains the record of political commitment by all parties to the full and timely implementation of the budget surveillance process.⁶ In addition to the Treaty and Council Regulations, member states have further developed the framework for co-ordination of fiscal policy in the EU in the form of a Council Opinion on the content and format of stability and convergence programmes, the Code of Conduct. It was first agreed on 12 October 1998 and subsequently revised by ECOFIN on 27 June 2001. The Code of Conduct incorporates the essential elements of the Council Regulation on surveillance into operational guidelines in order to assist the member states in drawing up their stability or convergence programmes. It also aims at facilitating the examination of the programmes by the Commission, the Economic and Financial Committee and the Council.

3.1 Prevention: the Regulation on Surveillance

The Regulation on surveillance was designed to give an early warning to a member state with the purpose to prevent it from incurring an excessive deficit situation. It foresees the submission by all member states annual stability and convergence programmes as part of this surveillance, which should take account of relevant economic factors such as the position of a country's economic cycle, the sustainability of the public finances, and the quality of public finances. Overall, the programmes include a medium-term objective of "close-to-balance or in surplus" and the adjustment path towards this objective. On a recommendation from the Commission, the Council examines these programmes and monitors their implementation. On a further Commission recommendation which triggers an early-warning mechanism, the Council gives its opinion on the programmes in which it may request the concerned member state to adjust its programme. If a significant divergence of the budgetary position from the medium-term objective, or the adjustment path towards it is identified, the Council addresses the concerned member state with a recommendation to take necessary adjustment measures. If the divergence persists or worsens, a public recommendation follows. Furthermore, the individual assessment of each programme is supplemented by an overall assessment. That is, the Council examines also whether the contents of the stability and convergence

⁴ Council Regulation (EC) 1466/97 of 7 July 1997.

⁵ Council Regulation (EC) 1467/97 of 7 July 1997.

⁶ Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17.06.1997 (97/C 236/01).

programmes facilitate the closer co-ordination of policies and whether economic policies of member states are consistent with the BEPG (Cabral 2001, 140-141).

3.2 Dissuasion: the Regulation on Excessive Deficits

The Regulation on excessive deficits was designed to ensure that countries take effective action if an excessive deficit has occurred. Having defined the term „excessive deficit“, the Regulation provides clarification on how to implement the Excessive Deficit Procedure and sets precise deadlines for the different steps of it. Amounts and mechanics of sanctions are also laid down in this Regulation.

3.2.1 Assessment of an excessive deficit position

If the government deficit⁷ exceeds 3% of GDP, it is not a sufficient evidence for the existence of excessive deficit. According to article 104c (2a) of the Treaty a government deficit above 3% of GDP is not excessive if that excess is „exceptional and temporary and the (government deficit to GDP) ratio remains close to the reference value“. While the Regulation on excessive deficits clarifies the concepts of ‘exceptional’ and ‘temporary’, it is silent on the notion of ‘close to the reference value’. The reason is that during the negotiations on the SGP no attempt was made to define the latter notion. There were lasting debates, however, on the definition of the term ‘exceptional’ which, as it was agreed, comprises two parts. Firstly, unusual events which are not under control of member states and which have major impact on public finances – these include natural disasters, and secondly, events of an economic nature – like severe economic downturn. This definition was offered by Germany and was readily agreed on by all member states. The most heated debate was on the definition of the term ‘severe economic downturn’. There were mainly two opposing opinions: one, from the German side, in favour of a numerical definition, and another, from the Commission, in favour of a qualitative definition. The German argumentation was based on the data about cyclical sensitivity of the budget in member states which showed that a 1% fall in GDP would lead to a 0,5 – 0,6% increase in deficit-to-GDP ratio. Thus, even with negative real growth of 2% of GDP, the automatic stabilisers should only lead to a deficit below the reference value of 2 to 3% of GDP provided that the concerned member state meets the medium-term position of close to balance. The Commission was arguing that a uniform rule would result in unequal treatment between member states which have different growth profiles, a sufficient degree of flexibility was required to cope with different economic circumstances of member states and different types of economic shocks. Furthermore, the potential technical difficulties of a numerical definition were pointed out, such as non-availability of quarterly data and significant time lags in it in some

⁷ Deficit is defined as general government net borrowing.

member states. Hereon, the Commission proposed to qualify the ‘severe economic downturns’ as being ‘clearly negative annual real growth’. The model which finally won the overall approval was the so-called „Box-model“. If, following this model, real GDP of a member state falls by at least 2%, then the excess of the deficit above the reference value is exceptional, e.g. it is regarded as a severe economic downturn. If the annual fall in real GDP is between 0,75 and 2%, the so-called grey area, the concerned member state can present arguments justifying the excess, namely as regards ‘the abruptness of the downturn or the accumulated loss of output relative to past trends’. If the fall in output is less than 0,75% then the member state breaching the 3% reference value can not appeal to the issue of ‘severe economic downturn’.

The assessment procedure on an excessive deficit position begins at the level of the Commission. When a deficit exceeds (or risks to exceed) 3% of GDP the Commission prepares a report which initialises the EDP. This report is sent to the Economic and Financial Committee for its opinion. Based on this opinion, if it considers that the deficit is indeed excessive, the Commission sends a recommendation for a Council decision. In its assessment the Council follows the guidelines of the „Box-model“ and the definition of a ‘temporary’ excess – „if forecasts as provided by the Commission indicate that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn“, – in order to decide whether the deficit is excessive or not (Cabral 2001, 141-145).

3.2.2 Deadlines for the steps of an EDP

The excessive deficit must be corrected no later than the year following the identification of the excessive deficit. It is important to note here that ‘identification’ is not the same as ‘occurrence’ of excessive deficit: it may occur in year t but is identified in year $t+1$, then it has to be corrected no later than $t+2$, that is, two years after it has occurred. There is also a possibility of allowing a longer period for the correction of the excessive deficit, if there are ‘special circumstances’, which are to be examined by the Council.

According to the Regulation sanctions can be imposed already ten months after member states submit their budgetary data⁸. From the submission date up to the Council decision on the existence of an excessive deficit and the issuing of the recommendations a period of no more than three months may pass. In its recommendation the Council sets a deadline (for example, four months) for the concerned member state to take effective actions to correct its deficit. When the deadline has elapsed, the Council assesses whether the expected results have been achieved. If the Council considers that the

⁸ According to Council Regulation (EC) 3605/93 member states must submit budgetary data twice a year: first until 1 March at the latest, afterwards until 1 September at the latest.

excessive deficit has not been corrected or no effective actions have been taken then it gives a notice to the member state within a month. In the light of its assessment on the reasons for the excessive deficit the Council decides which time limit to set for its correction. If the member state fails to correct the excessive deficit before the deadline set in the notice, then within two months sanctions will be imposed. However, if the Council considers that effective actions have been taken, then the procedure is stopped. But if the action taken by the member state is subsequently not being implemented or is considered inadequate then the procedure moves immediately to the step following the one at which it had stopped (Cabral 2001, 145-148).

3.2.3 Application of sanctions

Neither the Treaty nor the SGP foresee that sanctions can be imposed automatically, contrary to the initial proposal of Germany. The automatic working of sanctions is impossible, argued the Commission during the negotiations on the SGP, because the Treaty provides scope for the Community institutions to exercise discretionary judgement, and this cannot be taken away by either secondary legislation or a new international treaty. As Germany did not want to amend the Maastricht Treaty, it didn't further insist on its proposal. Thus, the Council has room to exercise judgement on the fulfilment of the conditions for imposition of sanctions and on their extent according to each specific case. There is, however, other type of automaticity laid down in the SGP in form of legally binding deadlines for key steps in the EDP, which are described in the preceding chapter.

Concerning amounts and mechanics of the sanctions, the Commission's opinion expressed during the negotiations on the SGP was that sanctions need to be (1) designed in a way to have a preventive deterrent impact, (2) easy to compute, (3) credible, (4) timely so that member states have a strong incentive to take prompt corrective action, and (5) designed such that they contribute to the adjustment process and do not risk unduly worsening the economic and budgetary situation. Hereon, the proposal on sanctions made by Germany⁹ was considered by many to be so severe as to be unworkable. Whether the final framework of sanctions is conform to the Commission's vision is doubtful.

The first step in the mechanics of the sanctions foresees a non-interest-bearing deposit in the amount calculated according to the rule:

$$\text{deposit in per cent of GDP} = 0,2 + 0,1 * (\text{deficit} - 3\% \text{ GDP})$$

which consists of a fixed amount of 0,2% of GDP and a variable component of 0,1% of the difference between the actual budget deficit and the 3% reference value. The fixed

⁹ For the initial German proposal on sanctions see chapter 2.3, p. 4.

amount demonstrates that there is a tangible difference between having and not having an excessive deficit position, and thus, provides an incentive to member states to make additional efforts to avoid the risk of sanctions. The variable component is designed to penalise further budgetary misbehaviour in a continuous fashion. Consequently, after the deposit has been made, the Council assesses every year whether the concerned member state has taken effective action to correct the excessive deficit. If, before two years have elapsed the Council considers that the excessive deficit has been corrected, then the deposit can be returned to the member state. The pecuniary cost of such a sanction is the interest foregone. If after two years since the deposit was made the excessive deficit is not corrected, the deposit is turned into a fine and the Council intensifies the sanctions through the requirement of a new non-interest-bearing deposit. This further deposit consists only of the variable component of the above formula. A non-interest-bearing deposit will be constituted every year and will be turned into a fine in the second year after its constitution until the concerned member state takes effective action or the excessive deficit is corrected. The sum of all the successive deposits is not limited. However, there is a ceiling for each deposit of 0,5% of GDP. The proceeds of the sanctions can be distributed among euro-area member states, which have no excessive deficit, proportionally to their share in total GDP.

According to the Pact Regulation, the amount of sanctions can be calculated only when the excessive deficit results from the non-compliance with the deficit ratio criterion. In the case of an excessive deficit resulting from the non-compliance with the debt ratio criterion no pecuniary sanctions can be applied according to the above-mentioned formula (Cabral 2001, 145-151).

4 The Implementation of the SGP: the first five years

Having won an insight into the origin of the SGP and its provisions, the attention can be drawn to the experience made during the implementation of the Pact. The influence of the new fiscal framework on budgetary performance and budgetary choices of the member states is assessed in chapters 4.1 and 4.2 respectively. The adaptations which were triggered by the SGP on the national level are introduced in chapter 4.3. The work of the enforcement mechanisms is reported in chapter 4.4 on the example of Germany. Chapter 4.5 summarises the lessons drawn from the so-far operation of the Pact.

4.1 Budgetary performance in EMU

In the years running up to the launch of the euro substantial decline in budget deficits was achieved in most member states and government debt was placed on a downward

trajectory. A notable feature of that consolidation undertaken by member states is that it took place during a phase of negative output gaps. This can be attributed to the Maastricht convergence criteria, to the incentive in form of entrance into the third stage of EMU, and demonstrates the potential effectiveness of EU fiscal rules provided policy actors fully assume their responsibilities. The improvement in public finances from 1993 to 1997 was underpinned by a steady improvement in the cyclically-adjusted primary balance¹⁰, whilst growth was generally weak (Figure 3), that is, member states have undertaken selective discretionary measures for fiscal consolidation. Since 1997, the CAPB of the euro area has not improved¹¹. The fiscal consolidation at the start of EMU was far from over, as several member states joined EMU with deficit levels just below the 3% of GDP, and were thus far from the objective of ‘close to balance or in surplus’. Also, although debt ratios were finally on a downward path in all member states, government debt levels remained high in historical terms.

In 1999, budgetary policy in the EU and euro-area was conducted for the first time in the context of the single monetary policy and the fiscal rules laid down in the SGP. In 1999 and 2000, the BEPG contained the recommendations to take advantage of better-than expected growth to achieve budgetary positions close to balance or in surplus no later than by the end of 2002. Though, the process of budgetary consolidation has slowed down since 1999, and in some cases has even reversed. The improvement in euro-area aggregate deficits from 2.3% in 1998 to 0.9% (revisited figure) of GDP in 2000 owes much to strong rates of growth, which boosted tax revenues, while expenditures remained broadly unchanged, and declining rates of interest¹². Indeed, this period of the favourable growth conditions provided the opportunity to reach the medium-term target more quickly or to increase budgetary safety margins. However, member states failed to use it, instead, several member states adopted measures to ease the tax burden over the forthcoming years¹³. While the cyclically-adjusted budget balance¹⁴ in the euro-area improved by 0.5% of GDP in 1999, much of this is explained by lower interest payments (Table 2). As shown in the Table 3, in 2000 the CAPB did not improve significantly again, indicating that on average no discretionary fiscal

¹⁰ CAPB nets out the budgetary impact of the automatic stabilisers and the change in the interest burden and thus gives the possibility to identify the role played by discretionary policy measures on budget positions.

¹¹ The CAPB improved by 0.3 percentage point of GDP in 1999, but this was progressively lost in the subsequent two years.

¹² For details see Commission 2000, 29.

¹³ The basic aim of such reforms was to simplify the systems, while at the same time widening the tax base and reducing marginal rates. They also included a substantial amount of tax relief (See Commission 2004, 24).

¹⁴ CAB gives a measure of the underlying trend in the actual budget balance, when taking into account the automatic effect on the budget of the economic cycle.

consolidation efforts were made. It even deteriorated in many member states, and especially in Germany, France and Italy, suggesting that they did not use favourable growth conditions to improve budgetary positions. Government gross debt to GDP ratios continued to fall in 1999 and 2000 (Tables 2 and 3), in continuation of the downward trend in the debt ratio initiated in 1997 and as a result of lower deficits, healthy economic growth, and the decision to allocate UMTS receipts to debt reduction. The picture at the member state level showed that budget balances in all 15 EU member states were below the 3% reference value in 1999 and 2000, and no country was deemed to have an excessive deficit position. Most countries had got a stock of debt close to the 60% reference value of the Treaty, although three countries (Belgium, Italy and Greece) still had debt ratios above 100% of GDP.

Slower growth, started 2001, affected public finances in subsequent years. Consequently, the euro-area budget position deteriorated in 2001 for the first time since 1993 and continued to deteriorate in 2002 and 2003. The aggregate deficit grew from its low point 0.9% in 2000 to an estimated 2.7% in 2003. The area-wide slippage of almost 2% of GDP over three years was the result of the working of the automatic stabilisers in a period of slowing growth, partially offset by declining interest payments (Table 4). Slightly less than 1% of the deterioration was due to discretionary factors – tax cuts which were only partially matched with expenditure reductions, – implying that fiscal policy was easier than it should have been. This impulse, however, was spread out over three years, that means that there was only a marginal expansion¹⁵. In some cases discretionary measures were relied on rather optimistic assumption on future growth prospects which have inevitably led ex post to budgetary targets being repeatedly missed.¹⁶ After several years of moderate decline followed by a stabilisation in 2002, the euro-area government debt to GDP ratio increased to 70.4% in 2003 (Table 5). Belgium, Greece and Italy continued to have debt ratios above 100% of GDP. As shown in the Table 6, budget positions at member state level were quiet dispersed in the last three years. Overall, deficit levels, both in nominal and cyclically-adjusted terms, have risen since 2000. However, in spite of a protracted period of low growth five euro-area countries (Belgium, Spain, Ireland, Luxembourg and Finland) had in 2003 budget positions in balance or in surplus, both in nominal and cyclically-adjusted terms. In contrast, the budgetary positions of Germany, France, Italy and Portugal remained weak over the whole period with nominal deficits ranging from 2.4% of GDP in Italy to 4.1% of GDP in France in 2003. These deficits in the large euro-area countries explain the

¹⁵ Usually, annual changes of up to 0.5% of GDP are considered as broadly neutral.

¹⁶ The tendency for most EU countries to base budget plans on overoptimistic growth scenarios is documented in Larch and Salto (2002), and Forni and Momigliano (2004).

deficit position for the euro-area as a whole. The nominal deficit has sharply deteriorated in the Netherlands and Greece reaching 3.2% of GDP in 2003. Hence, in that year nominal deficits were above the 3% of GDP reference value in four euro-area countries: Germany, France, Greece and the Netherlands. To conclude, the data suggests that in most cases the budgetary problems facing member states today can be traced back to the failure to run sound fiscal policies in the early years of EMU when growth conditions were favourable.

4.2 Role of the EMU fiscal framework in influencing national budgetary choices

As it is obvious from the above overview, the first five years of EMU are highlighted by the difficulties in maintaining budgetary discipline and by the persistently low growth. Relevantly the question arises, whether the rules-based fiscal framework adopted at the EU level had any impact on budgetary choices of the member states. To this end a number of studies have been made. On one side, analyses show in general that after the introduction of the EMU fiscal framework fiscal authorities became more concerned about the need to run low budget deficits. Ballabriga and Martinez-Mongay (2004) analyse systematically the robustness of the debt parameter in estimated fiscal rules with respect to sample split and show that in most member states the increase in the debt stabilisation objective occurred in the middle of the nineties. This means that budget balances became more sensitive to debt levels and thus there was an impact of the EU fiscal framework in affecting the choices of fiscal authorities. On the other side, the results of the analysis of Hughes-Hallet et al. (2004), based on empirical investigation of the determinants of the probability of running deficits in excess of 3% of GDP in EU countries, while indicating that the introduction of the SGP reduced the probability of a breach of the 3% deficit limit, show a statistically significant upward trend in the probability of a breach of the 3% limit after 1998.

Concerning the low growth during the first five years of the EMU, the study of the Commission (2004) supports the idea that in the absence of the EMU fiscal framework the growth in the euro-area were even lower. The analysis involved econometric estimation of counterfactual budget deficits that would have prevailed in the euro-area in the absence of the EMU fiscal framework. Such counterfactual budget balances have in turn been inputted as shocks to the Commission QUEST macro model¹⁷ to simulate the economic impact of such an 'absence of fiscal discipline'. The estimates show that on average, over the 1994-2004 period, the euro-area primary balance would have been higher by 0.88 GDP points in absence of the EMU fiscal framework. As shown on Figure 4, the simulations project that the GDP of the euro-area would have

¹⁷ A description of the Commission QUEST model is contained in Röger and in't Veld (1997).

been higher in the early years of EMU due to higher aggregate demand associated with the implied fiscal expansion. However, such positive impact on output appears rather low and turns negative after some years due to private investment crowding out. Thus the absence of the EMU fiscal framework, by changing the behaviour of fiscal authorities, might have prevented growth in the euro-area making it even lower compared with actual figures (Commission 2004, 63).

An additional issue of interest is whether the introduction of the EU fiscal framework has led to a less counter-cyclical, or more pro-cyclical, conduct of fiscal policy. According to the analysis of Gali and Perotti (2003), in which fiscal rules for the discretionary budget deficit are estimated over the period 1980-2002 for euro-area countries, since 1992 fiscal policy in the euro-area became on average more counter-cyclical, i.e. there was a bigger negative response of the CAPB to the output gap, and that appears to be a trend that affects other industrialised countries as well. Yet, there is still some room to go before EMU countries attain the degree of counter-cyclicality of their discretionary fiscal policy that characterises other industrialised countries. This result is consistent with the view that in the pre-EMU period counter-cyclical fiscal policies in member states were the exception rather than the rule. Therefore, Maastricht seems bringing to an end an era of pro-cyclical discretionary fiscal policies.

4.3 Implementation at national level

The Maastricht Treaty includes a specific provision¹⁸, which calls for the governments of the member states to ensure that their national budgetary procedures and institutions enable them to comply with the obligation to maintain sound and sustainable public finances. To this end, a number of EMU countries have adjusted their budgetary procedures to some extent in recent years, but in most countries there is still a lot of scope for improvement. Responding to the constraints of the SGP, essentially three types of adaptations at national level can be categorised: (1) expenditure control mechanisms in order to fulfil the deficit criterion; (2) medium-term budget planning procedures, responding to the medium-term targets set by the SGP; (3) mechanisms to bind in sub-national government levels, as the deficit (and the debt) criterion refers to the overall fiscal position of the country.

While in some countries multiannual budgeting systems are linked to short and medium-term expenditure control mechanisms, in other countries it is not the case. So, expenditure control mechanisms are established in Sweden and Finland with nominal expenditure ceilings; real expenditure targets exist in the Netherlands, including the rule that overruns have to be balanced in the year they occur. The new organic law in France,

¹⁸ Art. 2 of the Protocol on the EDP

adopted in 2001, includes provisions on expenditure programming over several years. Belgium has had, since 1996, a multiannual programme referring to the permissible overall outcome, but not on the annual revenue and expenditure. It furthermore introduced the so-called ‘anchor principle’ recently, limiting the spending per month and thus increasing the monitoring capabilities of the appropriate bodies. Italy adopted the Bassanini’s decrees in 1999 – the intra-governmental adaptations to enhance expenditure control. In some member states medium-term budget planning procedures were established already prior to the Maastricht Treaty or the SGP (e.g. Code for Fiscal Stability in the UK), while a number of member states have introduced multiannual budgetary frameworks only recently: Ireland, Italy, the Netherlands, Finland, and Sweden (Commission 2001, 38).

A third type of adaptation at national level refers to the contribution of the various levels of government to the general government balance under the SGP. The medium-term ‘close to balance or in surplus’ requirement of the SGP applies to general government, but in most EU countries it is the central government that commits to this objective on behalf of the whole general government without much involvement of lower levels of government. Lacking co-ordination, commitment and enforcement mechanisms at the national level with decentralised responsibilities may aggravate the political deficit bias and strengthen pro-cyclical tendencies in fiscal policy (see Pisauro 2001). The ‘financial significance’ of sub-national government in the SGP context depends upon the part of total general government expenditure they account for, and the existence of independent powers of borrowing and the possibility to claim transfers from the central government to cover financial shortfalls (Commission 2001, 44). The percentage of sub-national government expenditure and financial autonomy differs substantially between the member states being relatively high in Belgium, Germany, Spain, Sweden, Finland and Denmark and relatively low in Ireland, the Netherlands and Portugal. Thus, different mechanisms to bind in sub-national government levels were established. This includes, inter alia, borrowing limitations for sub-national governments and direct balanced budget constraints, as introduced in 2000 in Sweden. In Spain, the recent General Law of Budgetary Stability obliges all levels of government to produce balance budgets. In case deficits occur, the relevant government or body has to restore budgetary equilibrium within three years at most. The Fiscal and Financial Policy Council co-ordinates the procedures between different levels of government. In Belgium, the High Council of Finance fulfils the same task. Since 1999, the federal government can limit the borrowing of the regions for two years, following a recommendation of the High Council of

Finance. Internal or national stability pacts have been concluded in Austria, Italy, and Germany. As an example, the development and adoption process of the German national stability pact is described in the next section. Some institutional adaptations have also been triggered off by the SGP on the national level. One example is the Financial Planning Council in Germany (Finanzplanungsrat) – the established forum for discussion on fiscal developments between all levels of government, which tasks now explicitly include the adherence to the provisions of the Treaty and the SGP. In Austria, co-ordination committees between the regions and within each Land have been set up in order to discuss intra-regional fiscal policy as well as budget implementation and budgetary plans. These committees are expected to improve in particular vertical co-ordination and could be used for early warning mechanisms in case of budget implementation problems. Before firm conclusions can be drawn on the effectiveness of each outlined arrangement in contributing to the overall fiscal objectives of the SGP more experience with their implementation is needed. A priori, a strong legal base and enforcement mechanism would be expected to contribute to the credibility and effectiveness of the arrangements.

As for national actors other than governmental actors, they do not have a real incentive to reorient their resources to the European level. The involvement of national parliaments in the SGP procedure, especially by debating the stability or convergence programmes is comparatively low. The endorsement of these programmes by national parliaments, which might strengthen the level of commitment by domestic actors to the SGP and raise their awareness, has not been an option for any of the member states. Concerning the attitude to stability or convergence programmes at national level, in some cases it is obvious that the programme updates are actually seen as some kind of rephrasing of national budgets and of other documents (i.e. multiannual programmes), but not as a document on its own (Linsenmann 2003).

4.3.1 German national stability pact

The deliberations on a National Stability Pact (NSP) started in Germany at the same time as the negotiations on the European SGP. This was clearly accelerated by the increased danger that Germany would only narrowly pass the 3% threshold in 1997 due to a deterioration of public finances, most importantly linked to the reunification of the country. Also with regard to the debt criterion, reunification had a great impact. The debt-to-GDP ratio deteriorated from approximately 40% at the beginning of the nineties to some 60% in 2002. There were several problems relating to the NSP in Germany. First, any proposal to further restrict budgetary autonomy of the Länder would imply

constitutional implications. The second problem was linked to an allocation of the annual deficit and possible fines within the EDP between Federation and Länder. As no agreement was in sight – both between Federation and Länder and between the Länder themselves, and at the same time, with Germany meeting the 3% threshold in 1997 and the decision on the start of EMU mid-1998, the adaptational pressure from the European level disappeared, both the federal government and the Länder governments lost any interest in pursuing the negotiations of the NSP. Looking at the political debates in Germany throughout the years 1999 and 2000, the SGP and a domestic equivalent was not in the centre of the discussion. With the deterioration of public finances in the course of the year 2001 and economic growth prospects darkening, the issue suddenly reappeared on the political agenda. Then, with first rumours being spread in Brussels about the intention of the Commission to propose a Council recommendation the deliberations on a NSP were accelerated. Finally, an agreement was reached on a ‘soft’ option of a NSP. Furthermore, in December 2001, amendments were made to the ‘Haushaltsgrundsatzgesetz’ – Law on Budgetary Procedures (for Federation and Länder) with respect to the Financial Planning Council (FPC), the established forum for discussion on fiscal developments between all levels of government. Both the Federal and the Länder level have committed themselves to reduce net borrowing with the aim of achieving budget balance. The FPC was authorised to make recommendations on a joint expenditure line for Federation and Länder and in the event of unfavourable developments to make additional recommendations in order to correct them. As a consequence of the ‘early warning crisis’ in February and after reports about strong expenditure overruns in a number of Länder, the Federal government pressed for a more ambitious reform of fiscal policy co-ordination in Germany. This resulted in a modification of the article 51a Haushaltsgrundsatzgesetz¹⁹ and an agreement on expenditure caps for the next two years for all levels of the government.

To conclude, while recent legal developments clearly constitute an improvement compared with the preceding rules, it remains to be seen how effective the new law turns out in practice. The federal government could not get a deal on a NSP with enforceable rules, both with regards to more binding recommendations by the FPC and to the allocation of possible fines vertically between the federal and the Länder as well as horizontally between the Länder themselves, because this kind of agreement was unattainable. It has to do with the fundamentals of the federal system, that is, with the complexity of the fiscal system, the constitutionally guaranteed fiscal autonomy and the

¹⁹ The new law contains a clear reference to the responsibilities of all levels of government, proclaims the overall aim of bringing the deficit down in order to reach a balanced budget, and states the competencies of the Financial Planning Council.

decision-making power of the Länder. On the other side, the federal state is more in need than other member state to amend existing national provisions in order to increase the potential likelihood of complying with the SGP. This pressure was even higher during the periods of 1996-1997 and 2001-2002 in which Germany came close or even surpassed the 3% threshold. This explains why the government pushed for a NSP at these times while between 1998 and mid-2001 it had shelved its proposal. Given the development in recent years, doubts can be raised that a 'proper' NSP can be concluded. This rather casual attitude to the implementation of EMU fiscal framework at national level resulted in a breach of the SGP, and consequently in an excessive deficit procedure, which is described in the following chapter.

4.4 Enforcement mechanisms at work

During the first five years of EMU five EDPs have been started by the Council. As illustrated on the Figure 5, the first country put in an excessive deficit position was Portugal in November 2002, then Germany at the start of 2003 followed by France in June 2003. In summer 2004 Greece and the Netherlands were also placed in an excessive deficit position by the Council (Commission 2004, 71). In what follows we show how the provisions of the SGP have been implemented for preventive and correcting purposes by the responsible parties, taking the case of Germany as example.

4.4.1 Early warning to Germany

In its decision process on activation of the early-warning mechanism the Commission uses three basic criteria: (1) the size of the budgetary slippage, i.e. extent to which budget positions diverge from the targets set down in stability or convergence programmes; (2) the reason for the budgetary slippage, i.e. whether the divergence of actual balances from target can be explained by cyclical or discretionary factors; and (3) the risk of an excessive deficit position, i.e. whether there is a risk of breaching the 3 % of GDP reference value. Furthermore, these criteria distinguish between slippage from budgetary targets in nominal and cyclically-adjusted terms, and take account of whether or not a country has reached the medium-term target of the SGP.

As to the first criterion, the budget deficit in Germany was as high as 2.7% of GDP in 2001, exceeding by a large margin the target set in the October 2000 update of the stability programme, 1.5% of GDP, and clearly approaching the 3 % of GDP reference value. Concerning the second criterion, the Commission noted that this divergence was mainly due to the unexpected economic slowdown. General government expenditure remained broadly on target; with some exceptions, most notably in the health care sector and at the level of some regional governments. To decide on the third

criterion, the Commission took the autumn 2002 forecast in consideration, which projected growth of 0.7% and a deficit of 2.7% of GDP. As shown on Figure 6, this would imply even wider divergence between the actual budget balance in 2002 and the target for that year. Given the downside risks to growth at the time, and the possibility of unexpected budgetary overruns, the Commission considered that the risk of deficits breaching the 3 % of GDP reference value could not be fully excluded. Interesting to note that German forecast for 2002 and subsequent period was much more optimistic: growth rate of 1.25% and budget deficit of 2% in 2002, which was considered by the Commission as not plausible. Motivated by the size of the budgetary slippage and the potential risk of an excessive deficit position, the Commission adopted a recommendation²⁰ to the ECOFIN proposing to give Germany an early warning.

At its meeting on 12 February 2002 the Council noted the slippage in public finances compared with the stability programme and considered that, while economic growth was weaker than expected, the possibility could not be ruled out that the 2002 budgetary deficit might come closer to the 3% of GDP reference value. However, the decision was met not to follow the Commission's recommendation. The reason given by the Council was that the German government made a firm commitment which „effectively responded to the concerns expressed in the Commission recommendation.“ The German authorities assured of making certain that the 3 % of GDP reference value for the general government deficit will not be breached, and confirmed the previous commitment to reach a close-to-balance budget position by 2004. In order to fulfil it, the government intended to closely monitor budgetary developments at all levels of government in 2002, including the Länder and the social security system. That stance on the part of the Council proved to be overly optimistic. The deficit in Germany quickly rose above 3% of GDP and in early 2003 Germany was placed in an excessive deficit position (Commission 2002, 45).

4.4.2 EDP against Germany

Following general elections in Germany in September 2002, the Minister of Finance publicly stated that the deficit for 2002 was likely to exceed the Treaty's reference value. On the basis of its autumn 2002 forecast projecting a deficit of 3.8% of GDP for 2002, the Commission activated the EDP by preparing a report on the budgetary situation in Germany²¹. The attention was drawn to the fact that the German deficit did not result from a severe economic downturn and was not due to an exceptional event,

²⁰ European Commission, Commission recommendation to the Council to address an early warning, IP/02/164, Brussels, 30.01.2002.

²¹ European Commission, Report on government finances in Germany, IP/02/1705, Brussels, 19/11/2002.

but rather the origins of this budgetary slippage can be found in 1998-2000 period, when insufficient efforts were made to strengthen the underlying budgetary position while growth conditions were favourable. Indeed, the cyclically-adjusted deficit started to rise again from 2000, not least due to stronger expenditure growth at the regional level. Based on an assumption of continued strong economic growth, Germany opted for the carrying-forward to 2001 of the 2002 stage of the tax reform and for a back-loading of the necessary budgetary consolidation efforts. Therefore, the excessive deficit can only partially be explained by cyclical factors; most of the deterioration in structural terms was due to large shortfall in corporate taxes and a strong rise in expenditures in the health sector. Consequently, with the advent of the business cycle slowdown, there was insufficient room for the operation of automatic stabilisers while at the same time preventing the deficit from rising above the 3% of GDP reference value.

Outcome data for 2002 confirmed a deficit of 3.6% of GDP and on 21 January 2003 the Council, on the recommendation of the Commission²², decided upon the existence of an excessive deficit position²³ and adopted a Recommendation with a view to bring the situation to an end. The Recommendation set a deadline of 21 May 2003 for Germany to take effective measures to correct the excessive deficit position, and a deadline for the correction of the excessive deficit position, as being the end of 2003.

The Commission 2003 autumn forecast showed a deficit of over 4% of GDP for 2003, implying that, contrary to expectations in spring that year, neither the nominal nor the cyclically-adjusted deficit were reduced despite the measures taken by Germany. Therefore, Germany was in non-compliance with the Council's Recommendation of 21.01.2003. Hereon the Commission issued two Recommendations²⁴ for the Council, informing that the action taken by Germany in 2003 was proving inadequate and as a result the excessive deficit will persist in 2004, in the first one; and requesting that Germany takes new measures to reduce the budget deficit by 2005 at the latest, in the second one. On its meeting on 25 November 2003 the Council did not adopt these Recommendations giving a reason that following the Recommendation of 21.01.2003, Germany has made a substantive adjustment by adopting several measures, which had a total impact of 1% of GDP on government finances. However, there was abrupt and unexpected worsening in cyclical developments, and growth rate turned out to be lower than previously forecasted, which made the effort to bring the deficit below 3% of GDP

²² European Commission, Commission opinion and recommendations for a Council decision and recommendation, IP/03/12, Brussels, 08/01/2003.

²³ Council Decision of 21 January 2003 on the existence of an excessive deficit in Germany. Official Journal L 34, 11.02.2003, p. 0016-0017.

²⁴ European Commission, Commission recommendation for a Council decision, IP/03/1560, Brussels, 18/11/2003.

much greater than expected in May 2003. Therefore, taking into account the proposals of German government for structural reforms which would boost potential growth and reduce the deficit in the medium- to long-term, the Council noted that too great a consolidation effort in one single year might prove economically costly in view of the prolonged stagnation in Germany over the last three years and the expected slow recovery. The deadline for the elimination of the excessive deficit in Germany was, therefore, extended – general government deficit is to be brought below 3% of GDP by 2005 at the latest (Commission 2003, 39).

On the basis of current policies, the risk of missing this deadline cannot be ruled out. Germany made progress in the reform of the public pension system and to a smaller extent in reforming the health sector. The expected effects, however, may not suffice, firstly, to achieve the expenditure targets for 2004 or 2005 and, secondly, to offset the long-term demographic impact on pension and health care expenditures. Another significant budgetary burden is constituted by unemployment-related payments and transfers to the new Bundesländer. Substantial concern is also caused by non-reliable real growth forecasts from the German side and based upon them policy commitments. The latest update of the German stability programme, while repeating that achieving a balanced budget is remaining central aim to budgetary policy, no longer contains a target date.

4.5 Lessons drawn

From the so-far experiences with the implementation of the SGP a number of lessons can be drawn. First, while monitoring compliance with the Treaty must focus on the respect of nominal budgetary aggregates, the importance of considerations concerning economic developments has increased in the implementation of the SGP. Second, the assessment of compliance with the recommendations presents a number of difficulties which were not foreseen. Difficulties were encountered in assessing ex-ante the budgetary impact of the measures taken in response to the Council recommendations, and in measuring the fiscal effort of EDP countries via changes in cyclically-adjusted budget balances between the moment in which the recommendations are addressed and the moment of assessment of compliance. In this respect, an important issue is that of disentangling changes in the CAB due to discretionary budgetary measures and changes associated with modified growth conditions. Third, the recent experience with the EDP has shown that attention should be given not only to the size of budgetary adjustment but also to its ‘quality’, that is, the consolidation measures should secure a lasting improvement in budget balances which should be geared towards a reinforcement of the growth potential. Fourth, the euro-area continues to grapple with the same budgetary

challenge they faced at the outset of EMU, namely allowing the full operation of automatic stabilisers during economic downturns while respecting EU budgetary requirements. Past weaknesses in the fiscal policy behaviour of several member states seem to be still prevalent: instead of taking the opportunity in periods of strong growth to pursue reform and budgetary consolidation, these countries continue to take corrective actions only when circumstances force them to do so against a background of poor economic growth (Commission 2004, 67). The problem is that the Pact does not work symmetrically, that is, it does not restraint governments' incentives to increase expenditure or cut revenue in favourable cyclical periods. Fifth, a general tendency has emerged in several member states in recent years to base budgetary projections on overly optimistic growth assumptions, which inevitably leads ex post to budgetary targets being repeatedly missed²⁵. The problem might be that the forecasting authorities are partisan. Thus, production of unbiased forecasts could be achieved by giving this task to an authority independent of the ministry of finance and the government²⁶.

Concerning the adaptation processes at national level, studies show that while "the reactions to the EC/EU system on the national level have reached a certain prominence ... no uniform pattern of reaction with regard to the constitutional, institutional and administrative nation state systems arises from here" (Maurer, Mittag, and Wessels 2003). While some member states decisively undertook „a dramatic turn around from traditional patterns of policy-making", others tended to undertake the adjustment reforms only when they get in the tight corner.

The credibility in the SGP framework was not aided by the Council's failure to issue an early-warning in February 2002, nor the subsequent ignoring of projections for the deficit level throughout 2002, and the decision not to endorse a Recommendation of the Commission against Germany and France in the context of the EDP in November 2003. This called into question the the viability and credibility of the existing rules-based framework, and indicated a lack of capacity and willingness on the part of member states to deal with growing budgetary imbalances (Commission 2004, 71). Already at the very start of the SGP there were doubts on the plausibility of the imposition of sanctions on sovereign countries, because of the political difficulty. In this system of fiscal surveillance, finance ministers are both responsible for drafting national budgets and have to decide whether they breach the SGP rules. The concern on the fact, that the Council being in charge of the final decision on the implementation of sanctions implies a risk of a partisan application of the rules, was expressed already in 1997 (see

²⁵ See footnote 16, p. 13.

²⁶ See Jonung and Larch (2004).

Amtenbrink et al.). Although countries that are in breach of the Pact do not vote on their own sanctions, they can hope for a certain amount of sympathy from their peers. Hereon the proposition was made that an independent fiscal enforcer would have a considerably higher power. Independence here means that the enforcing review panel is disconnected from the political bodies that set the fiscal policies. But this does not seem a viable alternative at present (Barysch 2003, 4).

While in the years running up to EMU substantial budgetary consolidation took place driven by the incentive of entrance into the Stage 3, afterwards there were no incentives to pursue further budgetary consolidation. The only motivation left was the threat of the sanctions, which was doubtful from the very beginning. That is, the SGP lacks a strong system of incentives to pursue sound fiscal policies. The debate needs to consider why large countries in particular have failed to meet their budgetary commitments. Apart the SGP, there are either no strong incentives to prevent member states from deviating from the non-binding political commitment to strive for a balanced budget in the medium-term. De Haan et al. (2003) argues that neither co-operation incentive²⁷ nor competition incentive²⁸ seem to have strong effect on the member states. Thereon, the EU should match any loosening of the Pact with stricter enforcement. Experience with national fiscal policy rules in different countries indicate that, without an effective enforcement and sanction systems, rules often turn out to be short-lived and thus ineffective²⁹.

This more controversial than expected implementation of the SGP, highlighted by the difficulties in maintaining budgetary discipline and by the persistently low growth, was constantly giving a push for further development in the SGP framework. The subsequent chapters, 5, 6 and 7, deal with the problems which were identified during the implementation of the SGP and the ways to tackle them.

5 Improvement of the budgetary surveillance framework

At the start of the EMU a number of issues concerning an exact definition and implementation of the SGP provisions were left open. The SGP together with the Treaty provide only a broad framework for the conduct of fiscal policies in the EMU.

²⁷ The co-operation incentive has to do with a concern that poor performance in any member state participating in the single currency weakens the performance and attractiveness of the euro-area as a whole vis-à-vis the rest of the world. Poor policy in any one member of the club decreases the quality of the club good and may generate a negative externality on the other club members (de Haan et al. 2003, 14).

²⁸ The competition incentive has to do with a concern that poor performance would weaken the reputation of a member state, which may diminish its leverage in the design and implementation of EU policies at large. In addition, markets may punish a poor performer to the extent that poor policies make that country less attractive for investment, whereas good performers would presumably enjoy greater profitability and thus increased investment (de Haan et al. 2003, 15).

²⁹ For reports on experience with fiscal rules in other countries see Daban et al. 2003, 27.

Thus, the member states and institutions had to react to the emerging economic and budgetary circumstances by ongoing development of practical fiscal guidelines. Some issues which have been already discussed during the negotiations on the SGP are again in the debates. The challenges to cope with can be divided into two categories. First, the process of budgetary surveillance which required clarification of the definition of an appropriate medium-term budget target, development of techniques for adjusting budget balances for the impact of the economic cycle, and assessment of long-term sustainability of public finances. These issues are dealt with in the present chapter. Second category covers the debate on the appropriate conduct of fiscal policy in the EMU. The key issues on the role of fiscal policy as an adjustment instrument and on the role and effectiveness of the automatic fiscal stabilisers are discussed in chapter 6.

5.1 The appropriate medium-term budget target

Looking back to the negotiations on the SGP, Germany initially proposed a uniform medium-term deficit target of 1% of GDP, arguing that it was clear, transparent and easily verifiable. The Commission argued that this deficit position would not provide an adequate cyclical safety margin in all countries, because there are large differences among them as regards the elasticities of budget positions to cyclical economic developments. Nearly all member states supported the Commission. The agreement quickly followed on a medium-term target of ‘close to balance or in surplus‘ which is both stricter than the initial German proposal and at the same time better reflects the differing budgetary and economic circumstances facing member states (Costello 2001, 115). Thus, the SGP demands that member states aim for „medium-term objectives of budgetary positions close to balance or in surplus“. However, the meaning and a quantification of the ‘close to balance‘ rule was left unclear and became later on one of the major issues in the debate on fiscal policy in EMU.

In order to give an operational solution, the Commission, taking in account the experience of the preceding years of implementation of the SGP, developed a methodology based on the concept of structural (or cyclically-adjusted) budgetary balance. The idea behind is that the budgetary position consistent with the Pact cannot be assessed by simply looking at actual deficits (or surpluses). In setting an appropriate medium-term target, countries should take into account the influence of fluctuations in economic growth on the government’s budget. This view is perfectly consistent with the statement of the European Council in the Resolution on the SGP: „ ... adherence to the objective of sound budgetary positions close to balance or in surplus will allow all member states to deal with normal cyclical fluctuations while keeping the government deficit

within the reference value of 3% of GDP³⁰. However, along with cyclical fluctuations there are non-cyclical factors, such as unexpected tax shortfalls, spending overruns, interest rate shocks, and so on, which affect budgetary outcomes. Therefore, a supplementary safety margin around the medium-term budgetary positions may be required.

Having defined the ‘close to balance’ concept, the next question to answer was: how to quantify the cyclically-adjusted balance which provides a sufficient safety margin to secure that the 3% of GDP threshold is not breached in normal cyclical economic conditions. Such CABs were designated by the Commission as ‘minimal benchmarks’. The Commission used the method by which the minimal benchmark is obtained as the difference between 3% and the ‘cyclical safety margin’, which is in turn given by the product of the country’s budget sensitivity times a value for the output gap that reflects the observed average amplitude and frequency of strongly unfavourable cyclical conditions (Commission 2002, 54). Naturally, the higher the sensitivity of the budget to the cycle and the higher the volatility of the economy, the higher the estimated safety margin is. In other words, the cyclical safety margin represents the deficit swing (in ratio to GDP) to be expected in the event of a worst case realisation. The minimal cyclical safety margins were first calculated in 1998, and recalculated by the Commission in the report „Public finances in EMU - 2000“ (2000, 51) to take account of revised budgetary sensitivity parameters³⁰ as well as the changeover to ESA 95³¹ national accounts. The latest estimates of the minimal benchmarks, calculated in 2002 and presented in Table 7, are computed on the basis of the production function technique to estimate output gaps³² and include some limited changes to budgetary sensitivities³³. Compared with the calculations of 1998, the estimated safety margins have on average been reduced by about 0.5 p.p., mainly as a result of lower estimated budgetary sensitivities but also because of the new output gap estimates. The lower estimated budgetary sensitivity is partly due to reforms in tax and benefit systems in recent years which have in most countries reduced tax progressivity and, in some cases, lowered the generosity of unemployment transfers. The difference is particularly noticeable for Spain, Austria, Sweden and the UK. The new values show that, on average, in the euro-

³⁰ The cyclical sensitivity of the budget had been recalculated on the basis of new provisional OECD estimates (OECD 1999). See Commission 2000, 52.

³¹ Up to the end of 1999, budgetary figures reported under the excessive deficit procedure and the SGP have been reported under the previous ESA version, ESA79. In general, under ESA95 GDP levels are higher, but the changes smoother. This did not have a major impact on the estimated maximum negative output gaps, with the exception of Greece where such a variable worsened somewhat. For the move towards ESA 95 and the difference between both see Commission 2000, 139.

³² Up to 2002 the Commission has used the so-called Hodrick–Prescott (HP) filter to estimate trend GDP and the output gap (Commission 2000, 63). For the detailed description of the new approach with the use of the production function technique see Commission 2002, 55.

³³ See Commission 2000, 55.

area and the EU as a whole, a CAB at -1.4 % of GDP would provide a large enough cyclical safety margin to let automatic stabilisers work without exceeding the deficit ceiling. In Belgium, Denmark, the Netherlands, Sweden and Finland, the minimal benchmark is estimated to be around -0.3% to -0.7% of GDP, whereas a small surplus is required in Luxembourg and Finland. Elsewhere, minimal benchmarks are close to the euro-area average, the exception being Austria where a somewhat smaller safety margin is needed. The divergence among member states depends in particular on the sensitivity of the budget.

These values are somewhat ‘softer’ than previous estimations, but remain largely in line with the results computed in other studies. IMF (1998) and OECD (1997a) find that a structural deficit for euro-area as a whole in the range of 0.5% to 1.5% of GDP and below 1.5% of GDP, respectively, would be enough to allow the automatic stabilisers to operate without breaching the 3% of GDP deficit threshold even in periods of pronounced cyclical slowdown. Similar conclusions were obtained by applying more sophisticated methodologies. Dalsgaard and de Serres (1999), in the context of an estimated structural VAR (vector autoregressive model), show that for a majority of EU countries a structural deficit between 1% and 1.5% of GDP would help to avoid breaching the 3% of GDP threshold with a 90% certainty over a three-year horizon. If governments aimed for a structural position between zero and 1% of GDP, the confidence horizon was extended to between five and seven years. The study of Barrell and Pina (2000), which involves application of methods of stochastic simulation, confirms that, if the countries adhere to the budgetary targets laid down in their stability and convergence programmes, the full working of built-in stabilisers and the respect of the 3% deficit ceiling are expected to be compatible (Artis and Buti 2001, 197).

Upon the practical use of the minimal benchmarks, the Code of Conduct adopted in 2001 states that “the Commission may continue using, where relevant, these ‘minimal benchmarks’ as an additional working instrument, but not as a target per se according to the Stability and Growth Pact.” When comparing the data on CAB over the 2000-2003 period (Table 6) with the minimal benchmarks (Table 7, third column) we see that only one half of the euro-area members managed to comply with these benchmarks over that period. CABs of Germany and France were at the benchmark value only in 2000 and slipped afterwards. Portugal’s values were not even close to the benchmark at any point in time. It is also important to note that non-cyclical unforeseen fiscal developments should also be taken into account as an additional safety margin. Artis and Buti (2000) conclude from their research that this additional safety margin must be of the order of

0.5 to 1% of GDP to cover for non-cyclical risks. The above mentioned studies suggest that member states which kept their benchmarks should have had enough room for manoeuvre over the cycle. Indeed, general budget balance data (Table 6, first part) shows close to balance or in surplus positions for the complying member states over the period 2000-2003. On the other side, Germany and France did not have that room and breached the 3% reference value already in 2002. From the perspective of the above named facts and studies, the problem of the breaching member states can be traced back to their failure to achieve the firm close to balance position, that is, to run sound fiscal policies in the ‘good times’ of 1999 and 2000 when growth conditions were buoyant, what led to the fact that there was insufficient scope for the automatic stabilisers to fully operate in the event of an economic downturn.

5.2 Taking account of the economic cycle

One of the most heavily criticised features of the EU’s fiscal framework is that the budget targets (and in particular the reference value for deficits) underpinning EU surveillance were set in nominal terms, and thus, do not take account of the impact of economic conditions on budget balances. Since 1999, however, considerable progress has been made to formally introduce the impact of the economic cycle into the assessment of member states’ budget positions. The Council opinions on some stability and convergence programmes recognised that the actual and structural budget positions of some member states may differ in the medium-term, as output gaps might still exist at the end of the time horizon of the programme. An important development came with the adoption in 2001 of a revised Code of Conduct on stability and convergence programmes, which explicitly recognised the use of the CABs and clarified its role in the assessment by the Commission and the Council on the compliance of the member states with the budgetary targets set down in their programmes. That is, the Code stated that account should be taken of cyclically-adjusted positions when assessing compliance with the medium-term budget target. These clarifications helped improve the assessment of member states’ budgetary positions under the SGP, and ensures that they go well beyond the simple verification of compliance with nominal targets.

Interestingly, already during the negotiations on the SGP the Commission has suggested that the primary focus should be put on cyclically-adjusted budget positions because the actual aim of the SGP was to ensure that member states have the budgetary capacity to deal with negative economic shocks. However, the member states voted in favour of nominal budget target arguing that there is no consensus on how to measure cyclical adjustment, whereas actual budget positions are readily observable and easily

understood. The early experience with the EMU have brought a broad consensus in academic and policy circles on the importance of considering underlying budgetary positions when reaching policy conclusions. But opinions still diverge on how in practice they should be calculated. Moreover, the measurement of CABs is subject to a number of uncertainties stemming from the estimation of the position in the cycle, e.g. the magnitude of output gaps, and the size of the automatic stabilisers. Significant progress took place also in this area: more comparable indicators across member states on the output gap and CABs were developed. (the Council 2001, 10) Meanwhile the methods are used whereby the cyclical budgetary component is inferred from the co-variation of government revenues and expenditures with output fluctuations. The CAB is computed as the actual budget balance (**B**) adjusted by the cyclical budget component. The latter is estimated as the GDP output gap (**G**), i.e., the percentage difference between actual and potential output, times the budget sensitivity to the output gap (**s**). Hence,

$$CAB = B - s * G$$

The values of the budget sensitivities used by the Commission are based on budget elasticities (i.e., the percentage change in budget items associated with a percentage change in GDP) estimated by the OECD (van den Noord 2000).

Among the measurement issues on which the debate has focused there was the approach for estimating potential output and output gaps. Until 2001, the Commission has used the so-called Hodrick-Prescott (HP)³⁴ filter to estimate trend GDP and the output gap. Such a statistical filter has a number of practical advantages. Firstly, only limited inputs are required, i.e. real GDP figures, and it is therefore easy to apply in an equal fashion across member states. It is also a transparent method in the sense that it is easy for other users to replicate the results. However, the HP-filter lacks a clear link to economic theory, making it difficult to understand the driving forces behind the results: this complicates its usage for economic analysis in a broader setting, for example, to assess the policy mix, wage setting, unemployment and inflationary pressures (Commission 2002, 54). Given the limitations of the HP method, member states and the Commission agreed that it would be preferable to move to a so-called production function (PF)³⁵ approach to calculate output gaps, which is simple and transparent, and which relies on a similar set of assumptions for different member states although taking account of specific national features. The output gap based on a production function provides more information about the sources of deviations from trend. The production function approach was endorsed by the ECOFIN Council of 6 November 2001 and

³⁴ For description see Commission 2000, 63.

³⁵ For description see Commission 2002, 55; and Denis, McMorrow and Roeger 2002.

constitutes now the reference method when assessing CAB position expressed in the stability and convergence programmes (Commission 2002, 55).

There are still differences in the details of the methodologies used by the Commission and the member states to calculate output gaps and to cyclically-adjust budget deficits using these estimated output gaps. For example, the budget elasticity used in cyclical adjustments by the Commission for the UK is 0.5, whereas the UK Treasury assumes an elasticity of 0.7. This may seem like a minor technical detail, but it could become important in the case when a structural budget deficit target were met using the national government methodology but narrowly missed using the Commission methodology. In practice, therefore, national governments would need to agree to a common methodology in advance of setting any such targets (EEO June 2004, 30).

5.3 The sustainability of public finances

The criticism on the SGP includes the issue that the Pact focuses almost exclusively on short-term objectives for the budget deficit and neither the stock of public debt nor the liabilities of public pension systems enter the Pact. Hence, countries with different medium- and long-term prospects and different debt levels are treated equally by the SGP. Moreover, critics argue that 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.³⁶ According to Ballabriga and Martinez-Mongay (2002), EMU has shifted fiscal policy to a shorter horizon compared with the pre-EMU period. Beetsma and Debrun (2003) analyse the decision of a government facing electoral uncertainty to implement structural reforms in the presence of fiscal restraints, such as the SGP, and show that the Pact may harm structural reforms, sacrificing future growth and sustainability for present stability.

Many economists argue that the sustainability of government debt levels should be the first criterion to judge the appropriateness of the fiscal policy stance of countries³⁷. Interestingly, the original German proposal called also for provisions on public debt in addition to the government budget target, according to which public debt had to be reduced below the 60% reference value. That proposal was denied with the argumentation that member states must anyway follow the Treaty obligation for public debt to be below 60% or on a continuous downward path, and that the compliance with the budget restriction would inevitably require a considerable reduction in debt (Costello 2001, 114). Indeed, it is well known that the 3% deficit norm will ensure that the 60%

³⁶ For a theoretical model, see Razin and Sadka (2002).

³⁷ See also Coeuré and Pisani-Ferry (2003) and Wyplosz (2002).

debt ratio can be kept constant provided the nominal growth of GDP is 5%³⁸. However, this leads to another often criticised issue, namely: the requirement of the SGP to balance the budget over the medium term makes the steady state target for the debt ratio be lowered from 60% to 0%. „A horrible change in objectives“,– argues de Grauwe (2003), which in the long-run can not be supported by good economic arguments, except as being a temporary strategy for the highly indebted countries (Belgium, Greece and Italy). Hereon, a suggestion of a differential debt ratio target according to the specifics of each country was made, with the argumentation, countries with well-funded pension systems which reduce the future pension liabilities of their governments can afford larger debt. But this proposal is not a Pareto improvement, as neither the proposal to use an index of institutional reform (Eichengreen 2003), in order to remove the disincentives for structural reforms, is. While such proposals are well-suited to tackle only one drawback among great deal of problems, they might even exacerbate some of them³⁹. Such reforms might require, for example, other estimates which may turn out problematic in a multinational context.

Hence, the framework of the SGP does not embrace a complete picture of the financial positions of governments, especially as regards the long-term implication of budgetary policies. Already in 1999 this failure was recognised by the ECOFIN Council and an increasing focus emerged on the need to consider long-term issues for budgetary surveillance to take a longer-term perspective going beyond the four year time horizon of stability and convergence programmes. The European Council of Stockholm of March 2001 decided that the long-term sustainability of public finances should be assessed as part of the SGP and the BEPG. This conclusion was an important extension to the framework for budgetary surveillance in EMU, in that it made an explicit commitment to examine the long-term sustainability of public finances.

After the definition chosen by the Commission, a sustainable public finance position constitutes a long-term compliance with the budgetary requirements of EMU, and in particular the Treaty requirement to keep debt levels below the 60% of GDP reference value, on the basis of current policies and projected trends for revenues and expenditures. That means, the sustainability of public finances is a multifaceted policy challenge which requires, aside from avoiding deficits and debt accumulation, that tax burdens remain at reasonable levels and that other non-age-related expenditures (structural reforms, infrastructure, R&D) are not squeezed out. The central threat for the

³⁸ This follows from the steady state relationship between deficit and debt ratios for given nominal growth rate of GDP, i.e. $d = b * y$, where d = deficit as % of GDP, b = debt as % of GDP, and y = nominal growth rate of GDP.

³⁹ See Buti, Eijffinger and Franco 2003, 22.

sustainability of public finances comes, however, from the substantial change in the size and age-profile of the EU's population in the coming years as the post-war baby-boom generation reaches retirement age, fertility rates remain low and life expectancy continues to increase. This will lead to pressure for increased spending on public pensions and health care. The latest available long-term budgetary projections for age-related expenditures, in a no-policy change scenario, show an increase of between 3 and 7 p.p. of GDP in most member states by 2050. In most countries, the budgetary impact of ageing starts around 2010, and the largest increases are projected to take place between 2010 and 2030.⁴⁰

In the meantime the Commission has carried out three assessments of the sustainability of public finances in EMU member states with respect to demographic changes in population, based on the stability and convergence programmes submitted by them in late 2001, 2002, and 2003. With the help of quantitative indicators backed up with qualitative information, the assessment intended to address three policy questions. First, is it likely that the budgetary requirements of the Treaty can be further respected on the basis of current policies and in light of the projected budgetary implications of ageing populations? Second, is the medium-term budget target and other policy measures outlined in the stability programmes compatible with improving the sustainability of public finances? Third, what is the main policy challenge facing member states and what reform measures should be envisaged?

The extrapolation of debt developments up to 2050 in a “no policy change” framework and under two scenarios: a “programme scenario”, where it is assumed that member states actually achieve the budget targets set down in their programmes; and a “2003 budgetary position” scenario, where the starting point is the current budget position; has produced the following results. On the basis of the 2003 stability and convergence programmes, there is a risk of unsustainable public finances (measured against the 60% of GDP reference value) emerging in some half of EU member states even assuming they achieve their budget targets set down in their programmes (Table 8). Hence, current policies are not sustainable and further policy measures are needed. Moreover, the risk of unsustainable public finances increases considerably if the member states do not achieve the SGP goal of budget positions of ‘close to balance or in surplus’. An indication of this can be seen by comparing the projected debt levels under the “programme scenario” with the “2003 budgetary position” scenario. This issue is especially relevant for the six euro-area countries with highest cyclically-adjusted deficits in 2003, i.e. Germany, Greece, France, Italy, Netherlands and Portugal. These

⁴⁰ For detailed projections on the impact of ageing populations on public finances see EPC 2003, 13.

results are visually presented on the Figure 7, which shows that debt developments for most member states follow a U-shaped pattern even assuming that countries actually achieve their budgetary targets. That is, in the coming decade or twenty years, debt levels are projected to decrease thanks to the running of balanced budget position. However, this trend would start to reverse once the budgetary impact of ageing starts to take hold, with the largest increase in most countries expected between 2020 and 2030. Therefore, further budgetary adjustment is required in many countries to complete the transition to sustainability in the long-term. There is however only a limited and fast closing window of opportunity to reduce debt levels.

The next quantitative indicator – a sustainability gap – measures the scale of budgetary adjustment required for a member state to reach a sustainable public finance position. The sustainability gap under the “programme scenario” indicates that in addition to consolidation efforts to correct the 2003 aggregate underlying deficit (which is over 2% of GDP in cyclically-adjusted terms), an additional permanent budgetary effort, equivalent to between 1 and 2 p.p. of GDP, is needed in member states where the sustainability of public finances is a matter of concern. Even countries which currently appear to be in a good position to meet the budgetary costs of ageing populations will face considerable challenges in maintaining sustainable budget positions in the very long run (EPC 2003, 41).

In order to reach policy conclusions and to provide operational reform guidelines, a case-by-case assessment of qualitative information examining the underlying causes of budgetary imbalances has been undertaken. The main qualitative features the Commission shaped into the assessment are: the current debt to GDP ratio, the impact of special factors as one-off measures or contribution to pension reserve funds on the budget balance, the current level of tax ratios and the robustness of long-term budgetary projections. Once quantitative outcomes are complemented with qualitative features, it results that, overall, nine countries still present risks of long-term sustainability and five of them (Belgium, Greece, Italy, Germany and France) have more serious problems. While the quantitative indicators show that Italy and Belgium are relatively well placed to meet the cost of an ageing society, the high level of the current debt and the need for high primary surplus over the next 10 to 15 years raise concerns on the depicted path. This will be a major challenge for them as it could imply running actual budget surpluses, which inevitably leads to competing budgetary pressures for tax cuts and/or increased public expenditures. For Germany and France, it is the medium-term budgetary profile that raises concerns. First, public spending on pensions and

health care in these countries is projected to grow at or above the average rate of the EU in coming decades. Secondly, the pace of debt reduction is slow due to persistent and large underlying deficits. Finally, they have relatively low employment rates, including among older workers and a low effective retirement age. Addressing sustainability therefore requires a more ambitious and comprehensive approach tackling all these challenges. The other four countries (Portugal, Spain, Netherlands and the UK) face some risks due to the medium-term budgetary development or, as it is the case for Spain and Portugal, due to uncertainties over the long-term projections of pension expenditures. To ensure sustainability, the main challenge is to reform the public pension system so as to contain any increase in spending as a result of ageing society. Finally, six countries (Ireland, Denmark, Finland, Austria, Luxembourg and Sweden) seem to be relatively well placed to meet the cost of ageing populations. However, in a number of Nordic countries high tax ratios (at over 50% of GDP) raise concerns in envisage of a risk that tax bases may become more mobile in the future which may make it more difficult for countries with high tax ratios to raise revenues.⁴¹

The efforts to assess the sustainability of public finances as part of the evaluation of stability and convergence programmes have proved useful, as a number of countries have concluded or are in the process of adopting the Commission's recommendations.⁴² They have also helped to shape the policy debate at both EU and national level. However, the existing indicators need some improvement. Given the uncertainties surrounding long-run budgetary developments, sensitivity analyses should be carried out for variables which have a significant impact on the evolution of the debt to GDP ratio. A more consistent and systematic link is needed between the results of the quantitative indicators and the qualitative information. In addition to improving existing indicators, there are considerations on developing alternative indicators to assess the sustainability of public finances. Various analyses⁴³ have been carried out on long-run risk factors to government financial positions, not only linked to ageing populations but also to climate change and globalisation. It is argued that governments face large contingent liabilities (either explicit or implicit) that are not recorded in government accounts. The Council also recognises that factors other than ageing populations affect the long-term sustainability of public finances. For example, changing household structures and increased female participation will affect public spending and taxation. In addition, as economic integration deepens, governments may find it increasingly difficult to raise tax revenues on mobile tax bases due to tax competition. These issues set ajar a door to a new comp-

⁴¹ For detailed policy conclusions per member state see Commission 2004, 45.

⁴² On recent pension reforms see EPC 2003, 72.

⁴³ See also World Bank (2002), and Heller (2003).

lex debate and new challenges for EMU in the next years.

Furthermore, to maintain the long-term sustainability of public finances structural reforms are indispensable. The Commission has recently announced that the interpretation of the Pact may be relaxed for the countries that are actively pursuing structural reforms. In its Communication of 27.11.2002⁴⁴ the Commission made a specific proposal that „the ‘close to balance or in surplus’ requirement must be interpreted to cater for the inter-temporal budgetary impact of large structural reforms (such as productive investment or tax reforms) that raise employment or growth potential, and/or which in the long-term improve the underlying public finances positions“. This proposal could easily be interpreted as a weakening of the commitment to sound public finances, and the Commission was aware of it. To avoid the impression that provisions of this nature would weaken the Pact, numerous safeguards were outlined in the Communication. The Council, however, raised concerns about the practical feasibility of making such a proposal operational while at the same time safeguarding the commitment to sound public finances. Finally, it was agreed to pay greater attention to country-specific circumstances, in particular to the longer-term sustainability and the quality of public finances with a view to increasing the growth potential of the EU economies.

5.4 Public investment and the EU’s budgetary framework

Commentators on the SGP say that the provision for budget positions of ‘close to balance or in surplus’ may cause disincentives for public investment. The argument is as follows. Maintaining budget positions „close to balance or in surplus“ implies that capital expenditure will have to be funded from current revenues, what presupposes a disincentive to undertake projects producing deferred benefits and entailing a significant gap between current revenues and current expenditures. 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. The idea that the disincentive is stronger during consolidation periods is largely shared in the literature and can be found in Oxley and Martin (1991), De Haan et al. (1996), and Balassone and Franco (2000). The recent analysis by Blanchard and Giavazzi (2004) on the question whether the EU’s fiscal rules has contributed to the decline in government investment in euro-area countries also showed that during phases of fiscal consolidation, capital expenditures are likely to be cut more heavily than current expenditures. To get to the bottom of these critical issues we look into the provisions of the SGP for regulations concerning public investment and examine the empirical studies to this topic.

⁴⁴ Commission Communication „Strengthening the co-ordination of budgetary policies.“ COM(2002) 668 of 27.11.2002,

While the existing fiscal framework provides no special treatment of public investment as regards the definition of the budget balance and consequently in terms of the budgetary objectives which member states must respect, the framework for budgetary surveillance does, however, take account of public investment as part of the assessment of member states' fiscal position. For example, member states are required to report public investment levels and plans in their annual updates to stability and convergence programmes. Public investment levels are also taken into account in the EDP, to activate which the Commission has to prepare a report in which it "...shall also take into account whether the government deficit exceeds government investment expenditure..." (Article 104(3) TEC). Thus, public investment does feature in the existing framework for budgetary surveillance, and in particular concerning the assessment of the budgetary position of member states. Furthermore, in its Communication of 27.11.2002⁴⁵ the Commission proposed that on a temporary basis, a planned increase in public investment could provide grounds for a flexible interpretation of the 'close to balance or in surplus' requirement, provided there was an adequate safety margin ensuring respect of the 3% of GDP reference value for deficits. The Council has also shown some flexibility in interpreting compliance with the 'close to balance or in surplus' requirement to reflect significant planned increases in public investment programmes⁴⁶.

Empirical work aimed at assessing the impact of the fiscal rules on government investment does not fully support the concerns about possible disincentives. Perotti and Gali (2003), for example, made some interesting and controversial conclusion from their analysis, namely, that the decline in public investment (as a share of GDP) observed over the past decade among EMU countries can be hardly attributed to the constraints implied by the Treaty and the SGP, since (1) other industrialised nations not subject to those constraints have experience an even greater decline, and (2) the decline in public investment was even greater before Maastricht. Turrini's (2004) empirical assessment, on the contrary, shows that there was some impact of the EU fiscal framework on public investment developments in the member states. Furthermore, Turrini finds that during the budgetary consolidation period of the mid-1990s, government investment was indeed cut relatively more than current expenditure. Figure 8 reports the average annual change in public investment shares in each EU country and in the EU aggregate during the nineties, distinguishing several sub-periods. The first sub-period chosen (1991-1993) coincides with Stage 1 of EMU. In those years, public investment ratios fell on average by almost 3.5% per year in the EU area. The reductions were concentrated in Italy

⁴⁵ See the footnote 44.

⁴⁶ See recent Council Opinions on the stability programme of Ireland and on the convergence programme of the UK.

(facing high and mounting interest payment on the stock of accumulated debt), the UK (coping with large deficits associated with the economic slowdown) and Finland (hit by a deep recession which turned into fiscal imbalances). The second sub-period (1994-1998) corresponds to Stage 2 of EMU. In that period, when the Maastricht calendar for monetary unification exercised the strongest pressure on governments, urging to keep their budget deficits below 3% of GDP as a condition for entering EMU, public investment registered the largest drop in the EU area (the ratio on GDP fell by almost 4% per year). Reductions occurred in all EU countries, with the exception of Ireland, Greece and Finland. However, since the launch of the euro, the third sub-period (1999-2002), government investment has stopped falling and increases took place especially in countries having reached a 'close-to-balance' position. In spite of the fact that in this period the Maastricht requirements for fiscal discipline continued to operate, integrated with the provisions contained in the SGP, the share of public investment on GDP rose on average in the EU area by more than 2% per year.

This data suggests that the effects of the fiscal discipline provisions of EMU were quite different before and after the introduction of the euro. The years preceding the introduction of the euro coincided with a particularly strong reduction in public investment shares in most countries. Conversely, the introduction of the euro coincided with a stop in the downward trend in public investment that characterised the EU since the early 70s (Commission 2003, 88). The Commission (2004) interprets the overall results of the analysis as follows. The requirements of macroeconomic convergence and fiscal discipline accompanying the process of monetary unification appear to have produced both a direct and an indirect effect on public investment. On the one hand, EMU is associated with a shift of resources towards public investment, keeping other factors constant. This direct effect may be due to reduced interest expenditure but also to changed governments' expectations concerning the state of their public finances induced by EMU fiscal framework. The expectation of lower future deficits and debts may have induced governments to devote a higher amount of resources to public investment. On the other hand, monetary unification induced an indirect negative effect of budget deficits on public investment. Starting with Stage 2 of EMU the requirement of fiscal discipline was strengthened by specific time deadlines and started to be perceived as binding. Thus, in order to qualify for the adoption of the euro, countries running relatively large budget deficits had to reduce their public investment expenditures to respect the EMU requirements of fiscal discipline. In support to this interpretation, the Commission (2003) brings evidence which suggests that the net

impact of the fiscal framework on government investment may be different depending on the country considered: while in countries running relatively large budget deficits in the 1990s the net effect may have been negative, public investments in countries with relatively low deficits and debt levels may have instead received a stimulus.

Supporting the above issue on the direct effect, Figure 9 shows that public investment and interest expenditure followed quite opposite tendencies during the past decades in EU countries. In the run-up to EMU member states were struggling to consolidate public finances in light of mounting public debt which was accompanied by a consequent increase in interest expenditure. Thus, the share of interest expenditure reached its maximum in the mid 1990s and declined in subsequent years. Public investment reached its minimum level around 1997 and stayed broadly constant afterwards. These dynamics are partly explained by the fact that interest payments and public investment tend to be substitutes. Interests on cumulated debt worsen the structural deficit of general government, requiring cuts in other expenditure components or tax increases to improve budgetary positions. Here for public investment is often more likely to be cut than current public expenditure since the former is made of fixed expenditures which can be delayed or moved to future periods with relatively low political costs, while the latter is constituted to a large extent by wages and salaries, so that cutting current expenditure may be politically costly since this would mean cutting public employment. Thus, the progress made by member states in reducing interest expenditure have set some resources free for other purposes, and among all for public investment. Furthermore, the Commission's suggestion on the indirect negative effect of fiscal rules on public investment gives a hint to a supplementary interpretation of Turrini's results. A stop in the downward trend in public investment after the introduction of the euro might be due to disappearance of any incentives to pursue further budgetary consolidation⁴⁷. De facto not worrying about the 3% limit member states didn't cut their public investment anymore.

There is an ongoing debate on the topic for a more specific treatment of public investment expenditures in the EU's framework for budgetary surveillance. The reform proposals by scholars and policy makers can be organised in three groups. First, to amend or reinterpret the EU legislation in such a way as to exclude investment expenditures from the deficit ceilings relevant to the EDP, that could be also implemented through a 'golden rule'⁴⁸. This would allow governments to engage in investment projects yielding a high enough social return, and stimulate the economy when

⁴⁷ See also chapter 4.5, p. 22.

⁴⁸ A 'golden rule' requires adopting of a dual public budget: one budget should only include current operations, a separate budget should be devoted to capital operations.

needed. Second, to create an agency to finance and manage public investment projects (Blanchard and Giavazzi 2004). Finally, to introduce Public-Private Partnerships (PPPs), which concern the transfer to the private sector of investment projects that traditionally have been executed or financed by the public sector. PPPs become an increasingly widespread practice in EU countries with the UK Private Finance Initiative as a pioneer in this area. Germany, Spain, France, the Netherlands, Portugal, Austria and Finland have also recently carried out PPP projects, mainly in the field of transport infrastructure. Thus, the discussion on the topic of public investment within the fiscal framework of the EMU is in progress. With regard to the strong empirical evidence, that investment in infrastructure and in human capital are key to boost long term economic growth, the need seems to be substantial to adjust the fiscal framework of the SGP to take account of public investments, in order not to hamper the growth in the EMU even through some indirect channels.

5.5 Aggregate fiscal stance as a target

In the recent debate on the SGP the issue on the aggregate fiscal stance for the euro-area as a whole reappeared. During the negotiations on the Pact, one of the suggestions of the Commission on the design of the fiscal rules was that the medium-term targets for single member states be accompanied by a budgetary target for the EMU area as a whole. The Commission meant to encourage member states to recognise the constraints on national fiscal policies in monetary union and to assess the aggregate fiscal stance for the euro-area in the light of monetary conditions. The suggestion was rejected by member states which argued that this additional provision was unnecessary, because there is an implicit optimal aggregate of budget balance, provided that all countries meet the medium-term objective. Moreover, they saw it as certain centralisation of budgetary authority in EMU which doesn't comply with the subsidiarity principle. It was argued that a deficit in one member state can not be justified by a surplus in another one, and that member states could not be expected to adjust their budgetary position so as to contribute their share to an aggregate target for the euro-area (Costello 2001, 116). Today, however, it is often criticised that the SGP disregards the aggregate fiscal stance. In a currency union, the argument goes, only the aggregate fiscal stance is relevant for the policy mix at the euro-area level and, as such, enters the reaction function of the ECB. While each country is responsible only for national fiscal policies, the aggregation of them may not result in an optimal fiscal stance at the euro-area level which, in turn, may not be suitable to ensure an adequate policy mix and to respond to large common shocks which would require a co-ordinated response. To meet the objective of an optimal aggregate budgetary

stance, the issue of policy co-ordination on EU level has to be addressed. However, there is still no clear doctrine on why and when co-ordination is necessary. It remains a disputed issue, intellectually and institutionally.⁴⁹

5.6 Conclusion

The first five years of the implementation of the SGP have unveiled a number of problems concerning the process of budgetary surveillance and showed the directions for possible improvement. Overall, the progress in defining of the ‘close to balance or in surplus’ concept, developing of the techniques for CAB calculation and improving the assessment of long-term sustainability of public finances has been impressive. Thus, the additional instrument of ‘minimal benchmarks’ allows to take into account the influence of fluctuations in economic growth on the government’s budget and, so, to set more appropriate and more country-specific medium-term targets. The new PF approach to calculate output gaps takes into account specific national features and provides information about the sources of deviations from trend. Both, the explicit commitment to examine the long-term sustainability of public finances and the detailed assessment by the Commission to this end prove to be useful in ensuring a better preparation for demographic changes in populations. Although there is a number of problems left, such as differences in methods used by the Commission and the member states to calculate output gaps and CABs, lack of indicators on long-run risk factors to government budgets, not sufficient focus on structural reforms, ignorance to the aggregate fiscal stance, and others, an ongoing debate on them gives confidence in their soon solving. While most of the reform proposals target only one specific drawback of the Pact, they could be processed with the objective to borrow the operational and compatible features from them which could be combined and implemented as an improvement close to Pareto one. For example, any increase in attention placed on debt developments should not be at the cost of less attention on deficit developments. The debt criteria can be introduced complementary to the deficit criteria to better qualify medium-term budgetary position of each member state.

6 The debate on the conduct of fiscal policy in EMU

As budgetary surveillance issues seem to be on the sure way to improvement, large concerns have been raised about the conduct of fiscal policy by member states and, in particular, as regards the role of national fiscal policies for stabilisation purposes. It is widely argued that given the loss of national monetary policy and the nominal exchange rate, budgetary policy may need to play a more significant role in smoothening the

⁴⁹ See also Viren (2001), Korkman (2001) and Casella (2001).

impact of country-specific shocks on real output. However, the fiscal philosophy of the SGP, to bring deficits close to balance and then let automatic stabilisers operate freely over the economic cycle, reflects widespread scepticism on the use of discretionary fiscal policies for stabilisation purposes. The intention of chapter 6.1 is to discuss pros and cons on active use of fiscal policy in the EMU framework by, inter alia, addressing the issue of effectiveness of discretionary fiscal policy and automatic stabilisers in subchapters 6.1.1 and 6.1.2 respectively. Subchapter 6.1.3 discusses the central impediment against the work of automatic stabilisers in form of politically-motivated fiscal policies. The failure of the SGP to work symmetrically over the cycle is considered in chapter 6.2. Chapter 6.3 concludes.

6.1 Active use of fiscal policy versus automatic stabilisation

The explicit goal of the SGP is to make fiscal policies contribute to the objective of price stability in the euro-area while ensuring enough room for manoeuvre for addressing asymmetric shocks at national level. An operational reading of the SGP requires distinguishing between the conduct of fiscal policy in the transition period (i.e. when there is still some way to go before achieving the close-to-balance target) and in the steady state (i.e. when the medium-term objective has been reached). In the transition period, the SGP unambiguously puts the emphasis on the achievement of medium-term targets of close to balance or in surplus. This implies that the orientation of fiscal policy should remain restrictive from one year to another. If negative shocks occur, automatic stabilisers would be allowed to play freely provided the consolidation path (i.e. the improvement in the CAB) to which the member state is committed is not put into question. Only if the actual budget balance gets uncomfortably close to the 3 % of GDP ceiling should an unexpected negative shock imply additional fiscal tightening. Of course, in the event of positive shocks, the same reasoning would imply a more-ambitious-than-announced out-turn for the actual budget balance. The role of discretionary fiscal policy in the steady state is not addressed explicitly by the Pact. However, three elements provide a framework for such a policy. First, the Pact states that fiscal policy should support the objective of price stability, which may imply discretionary measures to hold inflationary/deflationary pressures in check. Second, countries with a preference for active fiscal management should create the necessary room for manoeuvre⁵⁰. Third, the Pact requires that such a policy should comply with the BEPGs. To summarise, the SGP, while putting the emphasis on the working of automatic stabilisers, leaves some room for interpretation to policy-makers on the desirability and appropriateness of conducting discretionary fiscal policy in EMU.

⁵⁰ See the July 2001 Code of Conduct (Part VII.1).

The arguments against an active use of fiscal policy can be summarised as follows. First, discretionary fiscal management has a major pitfall related to implementation lags. That is, ex ante counter-cyclical measures might have pro-cyclical ex post effects as policy-makers do not have perfect foresight of future (and even ongoing) economic developments. Second, if sharing a single currency brings about higher trade integration, foreign trade spillovers will increase, thereby reducing the effectiveness of domestic fiscal policy⁵¹. Third, the possibility of free-riding (gaining from expansionary discretionary fiscal policy while not bearing its costs) at national level may induce an expansionary bias. As a result, the public-debt level in the euro-area may rise above sustainable levels, crowd out productive capital and, from a longer-term perspective make it more difficult to tackle the budgetary consequences of ageing. Fourth, discretionary fiscal policy actions are difficult to reverse. To avoid debt accumulation, discretionary easing during slowdowns should be matched by discretionary tightening in upturns. The political difficulties with discretionary tightening measures could entail a deficit bias. Fifth, like monetary policy, discretionary fiscal policy is subject to time inconsistency, i.e. there is a temptation for governments to announce one policy now and follow another one later. Sixth, inappropriate fiscal policies in several countries, if carried out simultaneously, are likely to have significant spillovers effects throughout the euro-area price developments and could therefore trigger counterbalancing action by the ECB. By creating an additional element of uncertainty discretionary measures could make the central bank's task more difficult in the face of cyclical fluctuations, as argued by Taylor (2000) (Commission 2002, 113).

Concerning the argument that the loss of the control over monetary policy and the nominal exchange rate leads to incapability to correct country-specific macro-economic imbalances, it can be attributed in particular to small economies experiencing cyclical divergence with average for the euro-area as a whole. An analysis conducted by the Commission (2002) summarises the conditions under which discretionary fiscal policy could be envisaged in EMU as a stabilisation device at national level. In view of the institutional constraints and economic inefficiencies characterising discretionary fiscal policy, letting the automatic stabilisers work should be the norm in the event of 'normal' divergence, the latter being associated with structural differences (Balassa-Samuelson effect) or small shocks. When automatic stabilisers fall short of providing a sufficient degree of stabilisation, like in the case of large country-specific demand shocks which lead to large divergence with euro-area average, discretionary fiscal action may be useful. While fiscal policy is more appropriate in the case of domestic-demand shocks, it

⁵¹ Notice, however, that this applies also to the effectiveness of automatic stabilisers.

is not well-suited in the event of external-demand shocks. Counter-cyclical fiscal policy is not appropriate to tackle supply-side shocks, – in some circumstances it may be necessary to limit the operation of automatic stabilisers via offsetting discretionary measures if the supply shock proves persistent. Overall, targeted fiscal measures may prove efficient, provided the source of the imbalance is clearly identified. Across-the-board fiscal measures need to be temporary and reversible. In order to avoid the typical pitfalls of discretionary policy, it may be desirable to strengthen the smoothing capacity of automatic stabilisers, rather than employing active fiscal management. The challenge here, however, is to attain this goal without increasing the supply-side inefficiencies of tax and benefit systems. In view of past fiscal failures and the stability-oriented framework provided by the SGP, any attempt at running discretionary fiscal policy for stabilisation purposes at the national level should be subject to careful examination. More specifically, it should be assessed, first, whether such a policy move would be desirable and, second, whether and under which conditions it would be effective.

6.1.1 The effectiveness of discretionary fiscal policy in EMU

It is argued that fiscal policy at national level is more efficient in the EMU framework than in the past. The efficiency increased due to, firstly, decreased crowding-out effects of fiscal policy through interest rates and exchange rates, thus, leaving national monetary conditions virtually unaffected, especially in the case of a small country; and, secondly, lower country-specific risk premia on interest rates, that is, fiscal expansion cannot fuel expectations of exchange rate depreciation of the national currency. However, recent empirical research aimed at assessing the impact of fiscal policy on output shows that the value of fiscal multipliers is rather low in most advanced economies, and that it has been falling. The relevant evidence is reported in Blanchard and Perotti (2002) and Perotti (2004) who used the estimate of structural VAR models. Hemming et al. (2002) brings econometric evidence and model-based estimates of fiscal policy effectiveness. Estimates of the impact of fiscal policy obtained from most applied calibrated macro models also indicate values for fiscal multipliers smaller than those predicted by standard Keynesian models.

The Commission (2002) has enriched the debate on the effectiveness of various discretionary fiscal measures in stabilising the economy by a number of simulations with the QUEST model⁵². Five discretionary fiscal measures have been tested for three representative countries⁵³: Germany (a large country whose policy stance has potentially large spillovers effects via foreign trade and its impact on monetary policy), Ireland (a

⁵² See footnote 17, p. 14.

⁵³ For assumptions and further settings of the model see Commission 2002, 127.

small, very open and flexible economy) and Greece (a small but less open and rather inflexible economy). The Commission points out that the results found are clearly model-dependent and should be viewed as an illustration rather than as hard evidence. The first conclusion yielded from the simulations is in line with most economic literature. It shows that the short-term fiscal multipliers are larger in the case of spending increases than in the case of tax cuts and, within the latter, are smaller for income taxes than for indirect taxes. Unsurprisingly, the smaller and the more open the country, the smaller the multipliers due to external leakages. The second conclusion is that the highest short-term multipliers are associated with budgetary items which are the most likely to be irreversible (i.e. public employment) and thus have negative effects in the medium-term (generally from the second year on). The third and again unsurprising conclusion, the impact on the euro-area interest rates are sizeable when a large country (here Germany) starts off with discretionary fiscal policy. This emphasises the need for discussing such policy actions in the Eurogroup prior to their implementation. The fourth result shows that the impact on inflation appears to be limited, especially in the case of small open economies. This casts doubts on the ability of discretionary fiscal policy to temper inflationary or deflationary pressures, unless the fiscal impulse is of a very large, somewhat unrealistic magnitude. Only a lower VAT would significantly mitigate inflation in the short term. However, it does not impact on core inflation. Similarly, discretionary fiscal actions have only a modest impact on the trade balance, which confirms the inability of fiscal policy to correct externally driven macroeconomic imbalances. Finally, a tax swap does not have a significant short-term impact either on the terms of trade or on the trade balance for small countries. Therefore, there is not much to be expected from this measure in terms of macroeconomic stabilisation, although it may be considered as part of a larger structural reform (Commission 2002, 127). To conclude, even in the cases in which a discretionary policy may be desirable, designing an optimal fiscal package and implementing it successfully remains a serious challenge for policy-makers, given the inherent difficulties in identifying the nature of the economic shocks in a timely manner and the existence of implementation lags with fiscal packages.

6.1.2 The effectiveness of automatic stabilisation

While discretionary policy should be used in limited cases and with caution, the question remains, – whether automatic stabilisers are always helpful in stabilising the economy and whether they are on their own sufficient in the face of strong asymmetric shocks. Automatic stabilisers are defined as cyclically induced changes in taxes and expenditures which reduce fluctuations of the economic cycle and, thus, cause the

budget balance to improve in years of high growth, and deteriorate during economic slowdowns. A number of studies have attempted to quantify the dampening impact provided by the operation of automatic stabilisers. Such estimations are in particularly challenging due to the complex interactions between fiscal variables, types of the shocks and reactions of the private sector. Some studies offer significant differences in estimates⁵⁴ which, as pointed out by Buti and van den Noord (2004), relate to the boundaries between automatic stabilisation and discretionary policy. Analyses relying on mainstream estimates find that discretionary policies have frequently been pro-cyclical in the past two decades⁵⁵.

The central question is: what cyclical smoothing can be expected from “pure” automatic stabilisation? The analyses with three leading macroeconomic models: QUEST of the Commission (Commission 2001); INTERLINK of the OECD (van den Noord 2000) and NiGEM of the National Institute of Economic and Social Research (Barrell and Pina 2000) have brought the following results. The simulations of the Commission suggest that the degree of smoothing provided by automatic stabilisers vary significantly under various types of shocks and across countries. The highest degree of stabilisation is provided under a shock to private consumption which is very “tax-rich”. The lowest – under an investment shock. In case of a temporary supply shock, automatic stabilisers help smooth output, but at the cost of higher inflation; as supply shocks typically send output and inflation in opposite directions. However, if the supply-side shock is permanent, automatic stabilisers may delay the necessary adjustment towards the ‘new’ level of potential output. In contrast, public finances that are conducive to real labour market flexibility and resource re-allocation foster the structural adjustment. Automatic stabilisation proved to be most effective in Germany, Finland and Sweden, whereas the lowest degree of stabilisation was obtained in Belgium, Greece, France and the UK. Under supply shocks the smoothing effectiveness was relatively low with much less cross-country variance.

The OECD simulations do not distinguish between the types of shocks and are therefore not directly comparable to the Commission simulations. Nevertheless, the OECD finds on average, a similar smoothing effectiveness, between 25 and 30% for the euro-area. The ranking across countries is however somewhat different. Finland and the Netherlands, with their large budgetary automatic stabilisers, obtain the highest degree of output stabilisation, while the degree of stabilisation is significantly lower in Austria, France, Greece and Spain.

⁵⁴ Van den Noord (2000), Mélitz (2002), Wyplosz (1999), and Barrell and Dury (2001).

⁵⁵ See Fatàs and Mihov (2002), and Brunila and Martinez Mongay (2002).

According to simulations performed with NiGEM, automatic stabilisers generally prove less effective than the above estimates suggest: in the range of 5 to 18%, with the euro area at 11%. Germany shows the highest dampening effects while, surprisingly, Finland features one of the lowest (just 7%). The lower stabilising effect appears to be due to a cyclical sensitivity of the budget to economic activity lower than normally estimated. Like in the Commission simulations automatic stabilisers are less effective in smoothing supply shocks than demand shocks.

Although, as a number of studies show, the total degree of fiscal stabilisation is relatively low in euro-area countries⁵⁶, the impact of automatic fiscal stabilisers may, at varying degrees, be reinforced by other mechanisms that operate to smooth the business cycle. For example, the behaviour of imports is sensitive to short-term fluctuations in aggregate demand and therefore helps to stabilise variations in economic activity. Reactions in financial markets to cyclical developments should also reinforce the fiscal stabilisation mechanisms. Finally, cyclical variations in labour productivity prevent sharp swings in the demand for labour and thus help to stabilise unemployment (Buti and van den Noord 2004, 19). Furthermore, the degree of smoothing provided by automatic stabilisation may change over time. EMU as such may increase the stabilisation efficiency of fiscal policy by dampening interest and exchange rate responses to changes in fiscal policy in individual member countries. Structural reforms may lead to lower fiscal stabilisation if they entail a reduction in progressivity of tax systems and less generous unemployment benefits. An obstacle to normal work of automatic stabilisers, which currently causes the most concerns, is fiscal policy driven by political considerations.

6.1.3 Political impediment against automatic stabilisation

From the beginning there has been a concern that the SGP would not be strong enough to prevent politically-motivated fiscal policies. Unlike the Maastricht convergence, sticking to the rules of the SGP may not pay politically. Once in EMU, the reward of entry is in the pocket, while the threat of exclusion has been replaced by sanctions that may not bite after all. So governments may be tempted to use fiscal policy for re-election purposes. Von Hagen (2003) and Buti and van den Noord (2004) argue that the experience in EMU to date lends support to this criticism. Overall, unlike the experience in the run-up to EMU, fiscal policies have had an expansionary bias and this may be related to the elections cycle. The authors summarise the predictions of the theoretical literature on fiscal behaviour in relation to elections as follows: (1) opportunistic behaviour implies fiscal policy manipulations before the elections; (2) uncertainty about the electoral outcome and the degree of polarisation induce governments to undertake short-sighted poli-

⁵⁶ See Mélitz (2002), Wyplosz (1999), and Barrell and Dury (2001).

cies; (3) most models predict tax cuts before elections while the implications for spending is less clear-cut; (4) electoral rules shape fiscal behaviour: majoritarian elections lead to larger fiscal activism focussed on targeted programmes aimed at shifting votes in marginal districts; proportional elections lead to increase of broad-based programmes.

Recent empirical works support these predictions⁵⁷. Von Hagen (2002) finds that the expansionary fiscal stance in the 1998-2001 period for years preceding the election has been twice as large as that in other years. Buti (2002) compares, for each year since 1999, the target for the CABs in the national stability programmes submitted two years earlier with the out-turn for the same year, and concludes that, while most countries missed their targets, deviations from target appear larger and more systematic in elections years. The results of the analysis by Buti and van den Noord (2004) show that in pre-election years, early election years and full-blown election years there is a bias towards easing discretionary fiscal policy.

This decisive political economy impedes the free working of automatic stabilisers in EMU: it is tended to be offset by pro-cyclical fiscal discretion. Considering the experience in other monetary unions like the collective states in the United States, it shows that states with the tightest fiscal rules (or that are enforced most strongly) are also the ones more inclined to build up reserves (often in the form of "rainy day funds") that allow them to let automatic stabilisers work over the cycle (Inman and Bohn 1996; Knight and Levinson 1999). If it is right that tight fiscal rules work out favourably for stabilisation policy, the conclusion might be drawn that in order to achieve more fiscal flexibility in EMU, the enforcement of the SGP should be strengthened, and not become more indulgent.

6.2 Asymmetric work of the SGP

One of the main flaws of the Pact is that it does not provide sufficient incentives for governments to save during good times. There is nothing in the SGP preventing countries from undertaking pro-cyclical expenditure increases and tax reductions during periods of strong growth (Buti and Martinot 2000; Korkman 2001). As a consequence of such policy the headline budget figures may not deteriorate, while the underlying budgetary position will, thereby leaving the countries without any safety margin in the event of a slowdown in economic activity. Fiscal tightening in the common boom could be desirable also to avoid a monetary tightening and an associated exchange rate appreciation with adverse effects on external balance and long-term growth (Korkman 2001, 299). 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

⁵⁷ See Persson and Tabellini (2002a, 2002b); Milesi-Ferretti, Perotti and Rostagno (2002).

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. As shown in Buti and Sapir (2002), 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 modest 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 (Buti, Eijffinger, and Franco 2003, 10). Therefore, the EU should think about ways to make the Pact work more symmetrically. The system of warnings and sanctions should be extended to treat countries that fail to stick to their fiscal promises during good times accordingly.

6.3 Conclusion

The euro-area seems continue to grapple with the same budgetary challenge they faced at the outset of EMU, namely allowing the full operation of automatic stabilisers during economic downturns rather than putting the emphasis to discretionary fiscal policy. The provision for fiscal policy to let automatic stabilisers play freely while discretionary policy should be confined to critical country specific shocks is a sound policy advice. Active fiscal fine-tuning should be subject to a careful case-by-case examination by the concerned country and by the Eurogroup given the potential spillovers. This assessment has to address both the desirability and effectiveness of discretionary fiscal policy. However, automatic stabilisation is not always effective either, – it depends crucially on the nature of economic shocks prevailing in EMU. Thus, for example, if supply-related shocks, especially if long-lasting, tend to prevail, structural adjustment rather than cyclical stabilisation will be required. In the event of large country-specific and domestically-driven demand shocks, counter-cyclical fiscal policy to supplement the operation of the automatic stabilisers should be envisaged. However, if the cyclical smoothing is considered too small, instead of immediately relapsing into fiscal activism, it would be helpful if governments first searched for ways to improve the effectiveness of the automatic stabilisers. Unfortunately, even if automatic stabilisers can be made more effective in a technical sense, their de facto effectiveness is undermined if political economy motives prevent them from working symmetrically over the cycle. If fiscal improvements in good times are wholly or partly handed out to the electorate, fiscal policy will fail to smooth the business cycle. Therefore, as suggested by Buti and van den Noord (2004), the roots of the current difficulties of the SGP have much to do with electoral budget cycles and a weak system of incentives to abide by the agreed rules, in particular, to avoid pro-cyclical policies.

7 Further strengthening of the SGP

Obviously, the improvement of the SGP is by no means finished. Naturally, there is not an unanimous view on the reform directions. While there is a number of radical proposals concerning changes in institutions and procedures, as described in chapter 7.2, the EU institutions have concentrated themselves on the clarification of interpretation and implementation of the SGP. As presented in chapter 7.1, recent efforts to strengthen the SGP do not aim to change the rules, nor to amend the protocols on excessive deficits. The reference values (3% GDP for deficit and 60% for debt) shall not be adjusted either.

7.1 Recent efforts to strengthen the SGP

In March 2003 the European Council has agreed upon seven recommendations concerning the implementation of the Pact, submitted in the March report by ECOFIN. Firstly, the Council confirms the provision on close to balance or in surplus position for the structural deficits of the member states, which is complemented by further monitoring of the actual deficits with respect to the 3% reference value. Then, the states which structural deficits do not comply with the SGP will be obliged to reduce their deficits by at least 0.5% per year. The recommended deadline for the abolishment of structural deficits is 2007. It should be ensured by all existing procedures that automatic stabilisers work symmetrically over the cycle and the states do not conduct pro-cyclical fiscal policies. The EDP should contribute to ensuring a satisfactory pace of debt reduction. In the surveillance of budgetary positions more focus is to be placed on debt and long-term sustainability, especially in respect of demographic ageing. In the assessment on the fulfilment of the SGP criteria country-specific circumstances must be considered. Finally, more attention is to be paid to the quality of the public finances in order to promote the growth potential. To that purpose, the composition of the planned budget procedures is to be carefully examined with respect to its contribution to growth and employment.

This modified interpretation of the Pact is leading to partly more strict and partly more flexible guidelines. More strict are the rules concerning the debt levels and the conduct of the pro-cyclical policies. It is pointed out that in the future the EDP will also be started when a member state does not fast enough reduce its debt level of more than 60% of GDP, or when pro-cyclical fiscal policy is conducted, although the deficit limit might be not breached. On the other side, the importance of country specifics and quality of public finance are emphasised. This is insofar welcome, as the Commission in its assessment of the fiscal stance can consider whether temporary fiscal difficulties are caused by structural reforms, which are favourable for middle- and long-term

developments. The practical impact of the recommendations of the Council is not clear yet. The interpretation of these guidelines by the Commission and the ECOFIN is vital.

More recently, the European Council of June 2004, adopted the new Constitution which to some extent strengthens the framework for multilateral economic surveillance, notably by reinforcing the Commission's powers: the "early warning" is to be issued directly by the Commission, and the decisions of the Council about launching the EDP will be based on Commission proposals rather than recommendations. The European Council, while reaffirming its commitment to the SGP as the framework for the co-ordination of budgetary policies, looks forward to further proposals of the Commission as well as contributions of Member States with regard to strengthening and clarifying the implementation of the SGP.

In a Communication⁵⁸ adopted on 3 September 2004, the Commission made proposals to strengthen economic governance and to clarify the implementation of the SGP. While the document stresses the Pact's positive contribution to macroeconomic stability, it also recognises that implementation over recent years has been inadequate. It intends to ensure a more flexible implementation of the SGP and proposes three courses of action to improve implementation of the SGP, which perfectly comply with the recommendations of the European Council. Firstly, increasing the surveillance of debt levels and taking into consideration the level of each member state's economic growth when defining an appropriate rate of consolidation. Secondly, adapting national targets for balancing public finance to the economic and budgetary situation of each country, rather than fixing them on an across-the-board basis as earlier. The deadlines for meeting the targets shall also be decided on a case-by-case basis. Thirdly, strengthening of the preventive nature of the Pact. In favourable economic climates, member states will be called on to achieve surpluses while during prolonged periods of economic slowdown, the exceptional circumstances clause should enable more flexible deadlines to be set for reaching a 'close to balance or in surplus' budgetary position.

Reform of the Pact requires in the meantime unanimity of the 25 member states and is, according to the Dutch Minister of Finance and President of the ECOFIN Council, unlikely to take place before the end of the year. Talks have commenced on 10 and 11 September during an informal meeting between Ministers of Finance in Scheveningen (Netherlands). Pivotal is, there is the willingness to tackle seriously the various issues at stake, which gives some optimism as to the capacity of the EU to move forward to strengthen economic governance.

⁵⁸ Commission Communication 2004, COM(2004) 581 final.

7.2 Alternative reform suggestions

In the debate on the need to reform the EU fiscal rules, several other approaches have been suggested. They have merits and disadvantages and it is beyond the scope of this work to discuss them in details. Summarised and arranged according to whether they advocate new institutions or new procedures, and whether they favour a domestic or an international approach, the reform proposals are presented in Table 9. The more radical proposals (quadrants III and IV) build upon the creation of completely new independent fiscal policy institutions, inspired by the philosophy underlying independent central banks. Here are the proposals of Wyplosz (2002), Calmfors (2003) and von Hagen (2003). Following the general notion of independent fiscal policy institutions advocated by Ball (1997) and Blinder (1997), the idea common to all of them is that implementation and enforcement of fiscal targets should be less partisan. Different points of view prevail as to whether the institution should operate on the domestic or the international level. A second group of proposals (quadrant II) advocates changes of rules or procedures within the existing set of international institutions. Casella (2001) argues that the Commission and the Council should determine only the overall size of the EU budget balance and issue deficit permits that member states can buy and sell. Other authors highlight the difficulties which result from the attempt to ensure long-term sustainability of public finances by imposing annual deficit targets and suggest to adopt fiscal rules that take account of medium- to long-term developments instead. The Debt Sustainability Pact by Pisani-Ferri (2002), the permanent balance by Buiter and Grafe (2003) and the variant of the Golden Rule suggested by Blanchard and Giavazzi (2003) are prominent examples. Eichengreen (2003) rejects the usefulness of numerical thresholds for the deficit or the debt arguing that the EU should focus on structural reforms through the use of an index of institutional reform. Another group of proposals (quadrant I) essentially advocates improvements in the national budgetary processes as a complement to the existing international fiscal framework in Europe. These less radical proposals were put forward for instance by von Hagen (2002) and by Mills and Quinet (2001).⁵⁹ Furthermore, Jonung and Larch (2004) suggest that an independent forecasting institution would be an important building block of any proposal for whatever fiscal framework one may favour, on either a domestic or international level. The reasoning: regardless of the framework one wants to build for the budgetary process to ensure specific objectives, unbiased forecasts – presumably produced by an independent authority – will always represent an improvement either in terms of fiscal performance or at least in terms of the accountability of discretionary fiscal policy. (Jonung and Larch 2004)

⁵⁹ For more detailed assessment of the reform proposals see also Buti, Eijffinger and Franco (2003).

Each of the proposals presented above draws the attention to one or more potentially serious problems with the design and implementation of the SGP. The suggestion to implement institutional and procedural reform highlights the need for an independent enforcer. The idea to move to a golden rule stresses the need to preserve the growth aspect of the SGP. A number of proposals highlight the excessive uniformity of the current rules. Taking into account the different levels of public debt points to the need to insert the sustainability dimension into the core of the SGP. The proposal of establishing a market for deficit permits tackles the problem of the pro-cyclical bias in good times. However, none of the proposals outlined above represents a Pareto improvement: while appropriate to tackle some of the problems highlighted in the debate, each of them does not solve all problems and may even aggravate some of them. Some reform proposals present the same element of inflexibility of the current regime (golden rule); others require estimates which may turn out problematic in a multinational context (debt sustainability pact, permanent balance rule); others again require a decisive jump forward in the integration of fiscal policy (procedural reforms). The adoption of some proposals (procedural reforms, independent Fiscal Policy Committee) would allow to tackle the transition problem by removing the 3% limit. But, without a preliminary period in which their effectiveness is tested, this would represent a leap in the dark. Also, from a political perspective, attempting to rewrite the rules from scratch may lead to a vacuum in which the current rules are suspended while none of the alternative options is supported by a sufficiently large political constituency.

8 Conclusion

Aiming to get to the source of the current tumult around the SGP, an assessment of the origin of the Pact, its provisions and implementation have been undertaken. Having been adopted with the purpose to ensure budgetary discipline of member states, which would support the stability-oriented monetary policy and give confidence in the economic stability of the euro-area, the Pact has been equipped with two mechanisms: the first one, aiming to prevent excessive deficits, and the second one, to ensure that effective actions are taken if an excessive deficit occurs. Its provisions define a medium-term budgetary objective and a nominal deficit ceiling for general governments of member states, set deadlines for specified enforcement procedures, and foresee sanctions in case of non-compliance. Right from the moment the SGP came into force the process of ‘learning by doing’ has begun. The assessment of budgetary performance of member states before and after the Pact came into force reveals the following results. While a

substantial budgetary consolidation has been achieved in the years running up to EMU, the experience in the early years of EMU has been disappointing: though several member states have managed to achieve budgetary positions ‘close to balance or in surplus’, the three largest members – Germany, France and Italy – and Portugal remained trapped in high deficits. However, the problems of the breaching member states should not necessarily be interpreted as signalling a return to the loose fiscal policies of previous decades, nor do they constitute an imminent threat to the sustainability of public finances. Though, this threat could easily materialise, unless countries achieve significant improvements in underlying budget positions over the coming years. The failure to improve underlying budget deficits over the past five years means that the euro-area continues to struggle with the same budgetary challenge they faced at the outset of EMU, namely allowing the full operation of automatic stabilisers during economic downturns, while respecting EU budgetary requirements. The situation also indicates the past weaknesses in the fiscal policy behaviour: the failure to pursue reforms and budgetary consolidation in periods of strong growth, and to take the corrective actions only when circumstances force to do so, mostly in periods of low economic growth. Notwithstanding, the SGP has helped delivering macroeconomic stability, which is illustrated by the budgetary trends in the recent downturn which compare favourably to the past when economic downturns were typically accompanied by a more pronounced deterioration in underlying budgetary positions.

A number of tensions, which have accumulated in the application of the SGP, have been solved quite successfully. Thus, the medium-term budgetary target has been interpreted anew to take account of economic cycle, more country-specific treatment in the surveillance process has been developed due to the concept of ‘minimal benchmarks’, the attention has been shifted towards the long-term sustainability of public finances and the challenge posed by population ageing. A useful debate has also taken place on the merits and feasibility of automatic stabilisers versus discretionary fiscal policies for cyclical stabilisation purposes. Moreover, a great progress has been made in strengthening the analytical basis for measuring the impact of the economic cycle on budgetary developments. The recent efforts to improve budgetary surveillance foresee also the increasing of the focus on debt levels and country-specific economic developments. Concerning the more radical reform suggestions which advocate new institutions or new procedures, while they do not seem to be a viable alternative at present, they contribute to the improvement of the Pact by pointing out its shortcomings and proposing possible ways to correct them. Helpful for future progress would be the

switch from a ‘Disputation’- method of exchange of points of view, where each participant persists on his own vision, to a ‘Consultation’- method, where the participants can detach themselves from their proposals, consider the suggestions of their colleagues, and together develop a Pareto close improvement.

Despite the so-far achieved important developments, some shortcomings are evident in translating this progress into the field of policy-making. Thus, the current difficulties of EMU's fiscal policy framework have little to do with the claim that its numeral rules make no sense. The fundamental problem is the weakness of the system of incentives to pursue budgetary consolidation. While such incentives were clearly present in the run-up to EMU, they may have been diluted somewhat by the launch of the euro. How to establish positive incentives to pursue budgetary consolidation and, in particular, to prevent pro-cyclical policies in ‘good’ times, so that ‘bad’ times could not surprise member states while they have no safety margin? This is a major challenge for the surveillance, and for domestic policies and institutions. The results of the assessment conducted in the work suggest that politically-motivated fiscal policies have made a substantial contribution to the breach of the reference value for deficit. In most cases, the implementation of the Pact’s provisions at national level, with the respect to both institutions and procedures, has appeared to be carried out sloppy. Interestingly, the first countries which have failed to meet their budgetary commitments were large ones, recently followed, however, by a few small ones. These three aspects must be considered in the future debates on strengthening of the incentives for sound fiscal policies. The first best solution to this problem were the change in the attitude of the member states to EMU and to sound fiscal policies so to regard them as a common good, – the so-called co-operation incentive which has to do with the concern that poor policy in any one member of the club decreases the quality of the club good and may generate a negative externality on the other club members.

Given the so-far efforts to improve the SGP, the following recommendations, based on the carried out investigation, seem to be conducive to further strengthening of the Pact. The available tools to judge the underlying budgetary positions can be improved, which will allow the Commission, the Council and the public opinion to better understand the fiscal strategy put forward by the governments and give appropriate recommendations. Among all, the reasons that have led to a given deficit have to be assessed, in order to decide on relevant guidelines and time for its correction. At national level, it is important that member states ensure that institutions are appropriate to the task of securing sustainable public finances. They must also search for ways to improve

the effectiveness of automatic stabilisers. If active fiscal fine-tuning is desirable, it should be subject to a careful case-by-case examination by the concerned country and by the Eurogroup, given the potential spillovers. Furthermore, the ‘quality‘ of each fiscal adjustment must be assessed with respect to its contribution to a lasting budgetary improvement and to growth potential. In order to work properly any co-ordination mechanism needs to be embedded in strong institutions, because co-ordination will always contain a considerable element of judgement. Thus, the possibility of independent enforcer and independent forecasts should be considered in the debates. An independent fiscal enforcer would have a considerably higher power and would contribute to credibility of the Pact, while independent forecasts would substantially lower the forecast bias, and the frequently ex post missing of the budgetary targets would be avoided. Furthermore, the chosen rules do not have to be rigid. As OECD (2002, 128) reports, experience illustrates that the types of rules that may be helpful during a phase of deficit reduction may no longer be sufficient later on. For example, both Canada and Switzerland modified their rules after the initial balanced budget objective was achieved, with Canada shifting the emphasis from deficit to debt reduction and Switzerland adopting an expenditure rule. When deciding on the appropriate rules, the trade-off between simplicity and adequacy has to be considered. While simplicity may be preferred to allow peer pressure, central monitoring and prevent moral hazard; heterogeneity of countries has a consequence that a one-size-fits-all fiscal rule is likely to be sub-optimal. Overall, while the SGP should remain a fundamental complement to the Maastricht Treaty, the objective of increasing flexibility while strengthening prevention and enforcement will require its revision.

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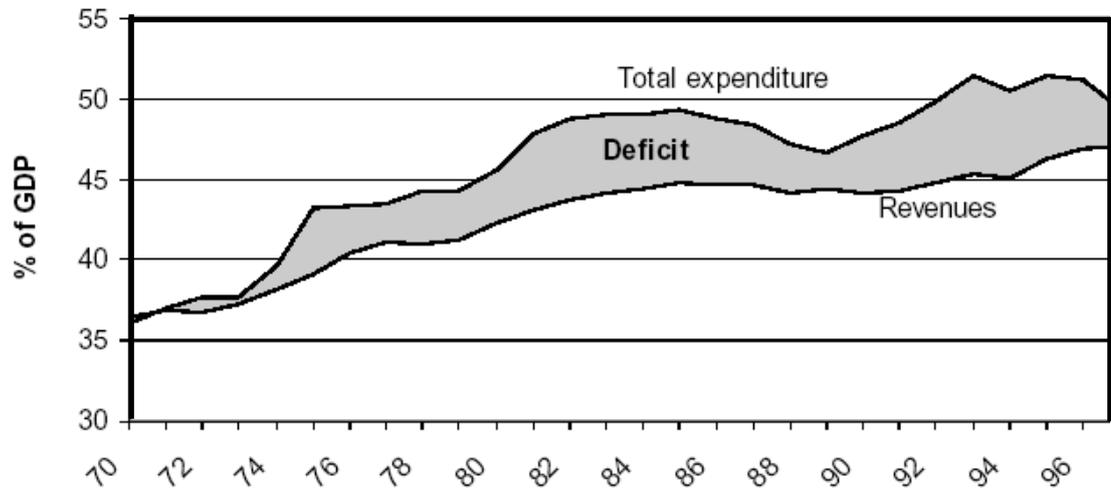
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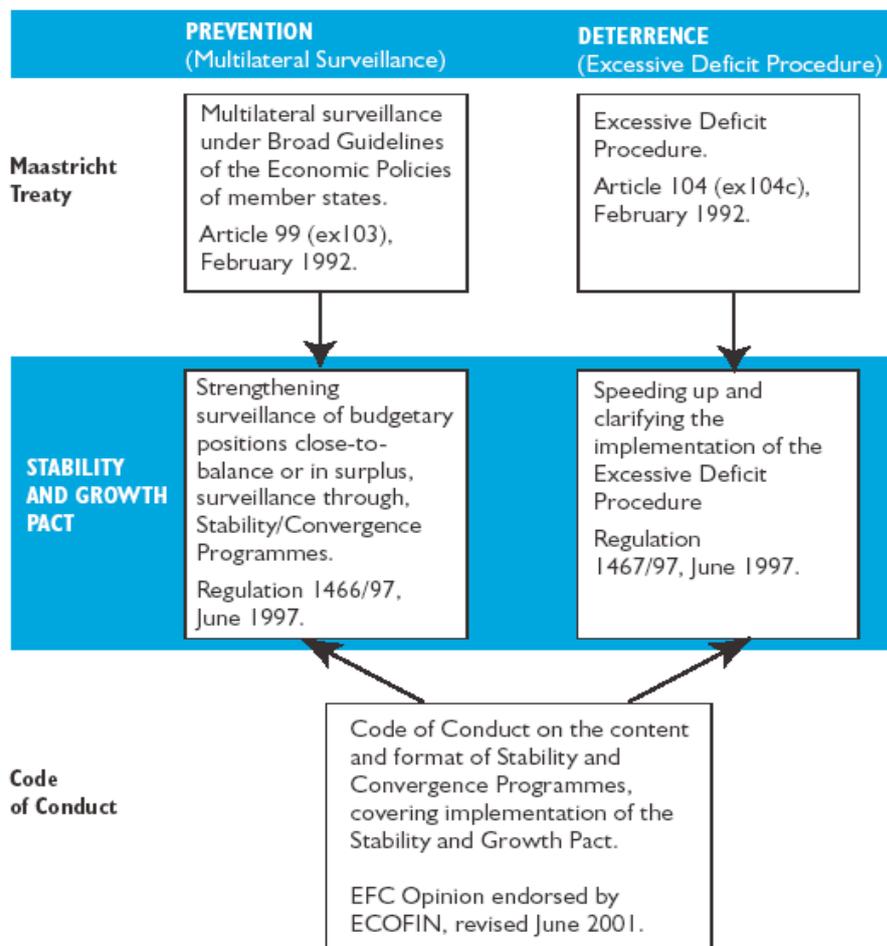
Appendix 1

Figure 1: General government: expenditure, revenues and borrowing in the EU, 1970-1997



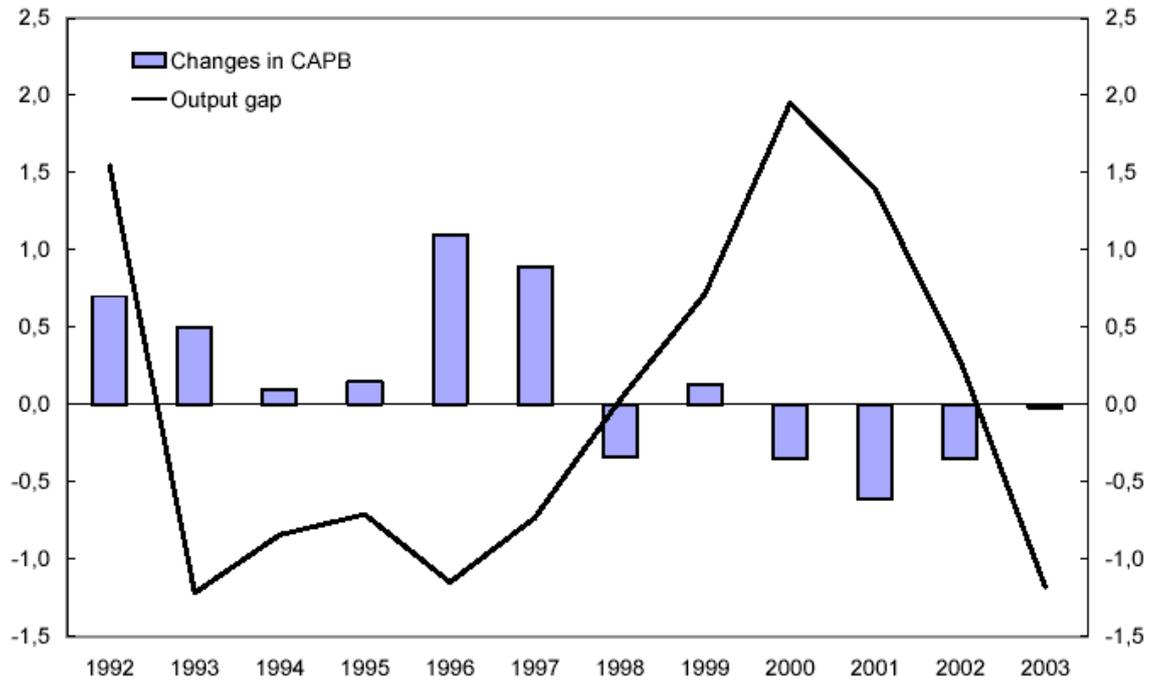
Source: European Commission (2000, 11).

Figure 2: The Stability and Growth Pact: prevention and deterrence



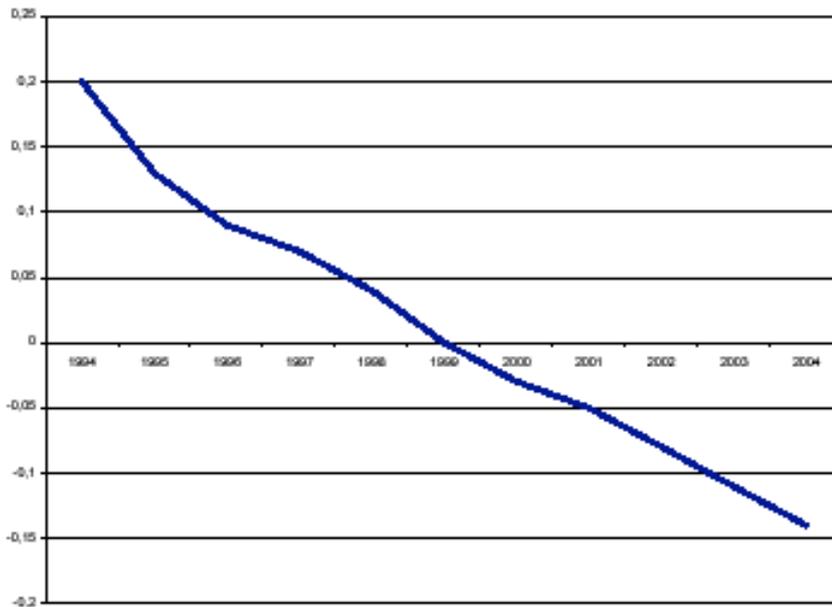
Source: HM Treasury (2004, 37).

Figure 3: Changes in the average euro-area CAPB and the euro-area output gap in 1992-2003



Source: European Commission (2004, 62).

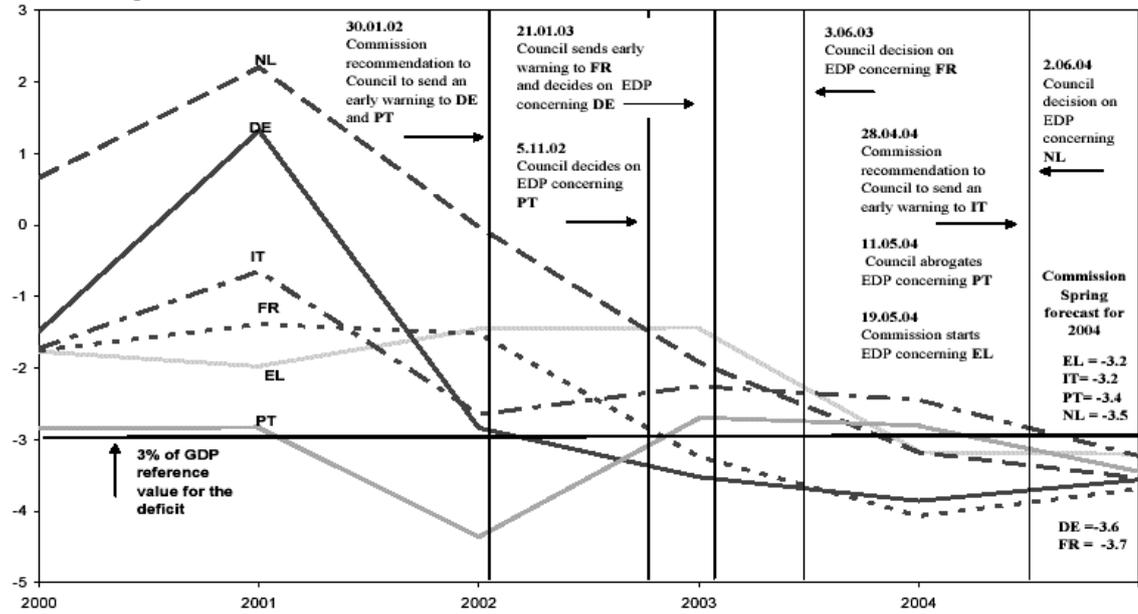
Figure 4: Euro-area GDP in absence of fiscal discipline, simulation with the Commission QUEST model (% change of GDP compared with baseline)



Note: simulated GDP in response to an increase in the average euro-area primary budget deficit of 0.88 GDP points over the 1994-2004 period.

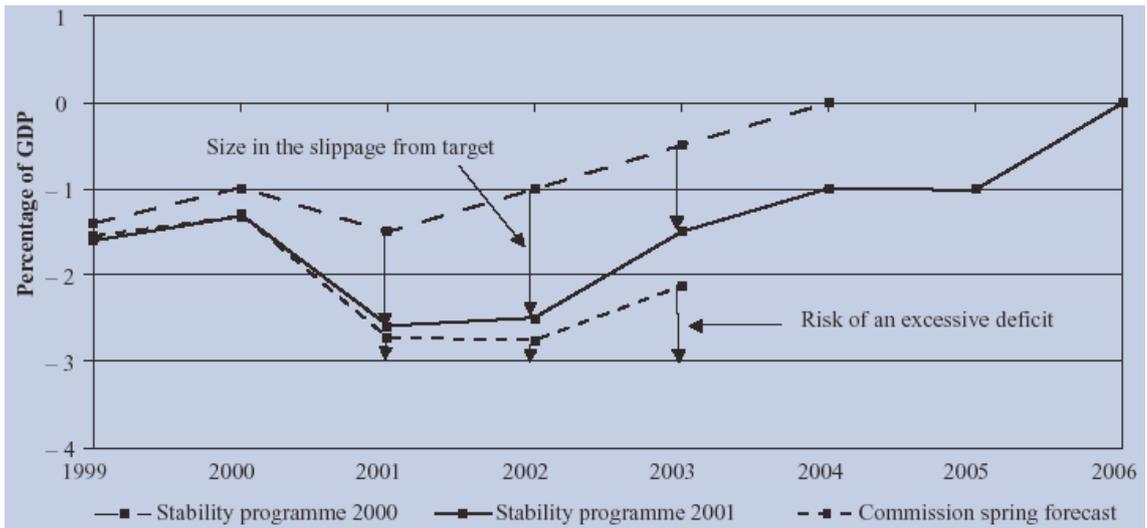
Source: European Commission (2004, 64).

Figure 5: Budget deficits and procedures launched by the Commission and the Council concerning 6 euro-area countries, 2000 – 2004



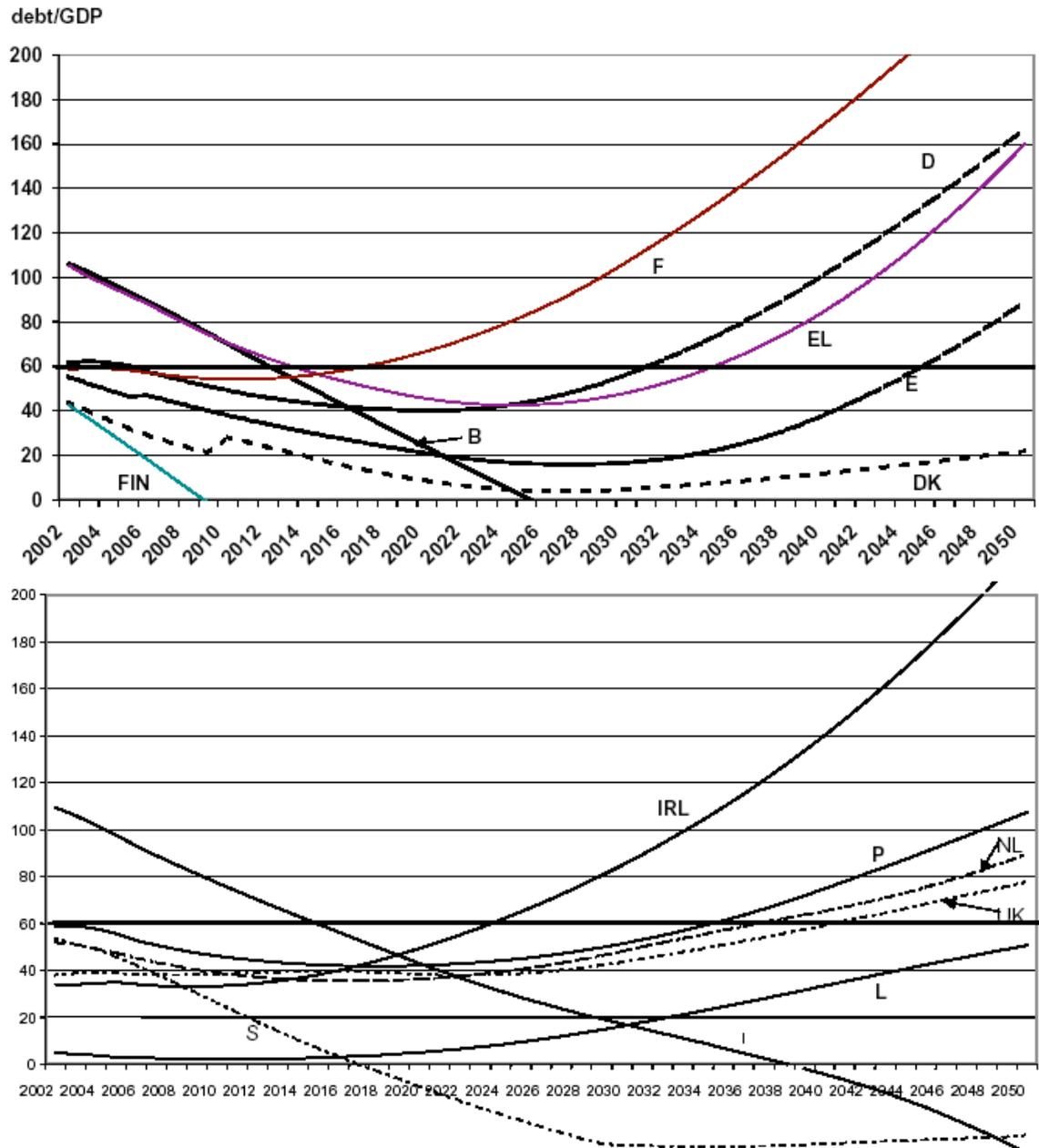
Source: European Commission (2004, 70).

Figure 6: Budgetary consolidation in Germany 1999-2006, as assessed in 2002



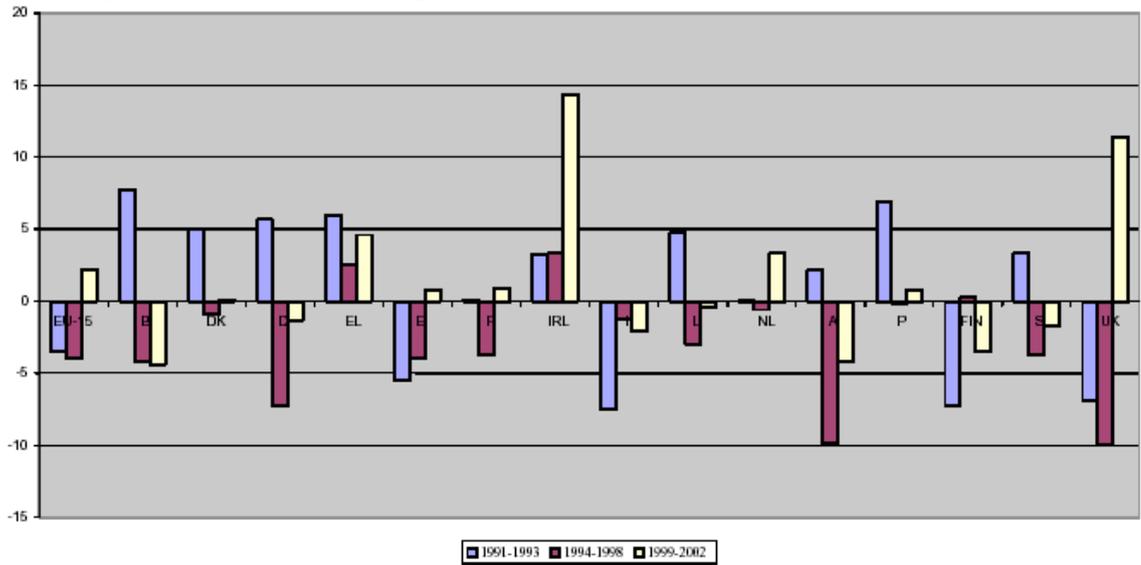
Source: European Commission (2002, 49).

Figure 7: Projected debt developments for fourteen EU member states (excluding Austria) based on compliance with the targets for 2006 set down in 2002 stability and convergence programmes



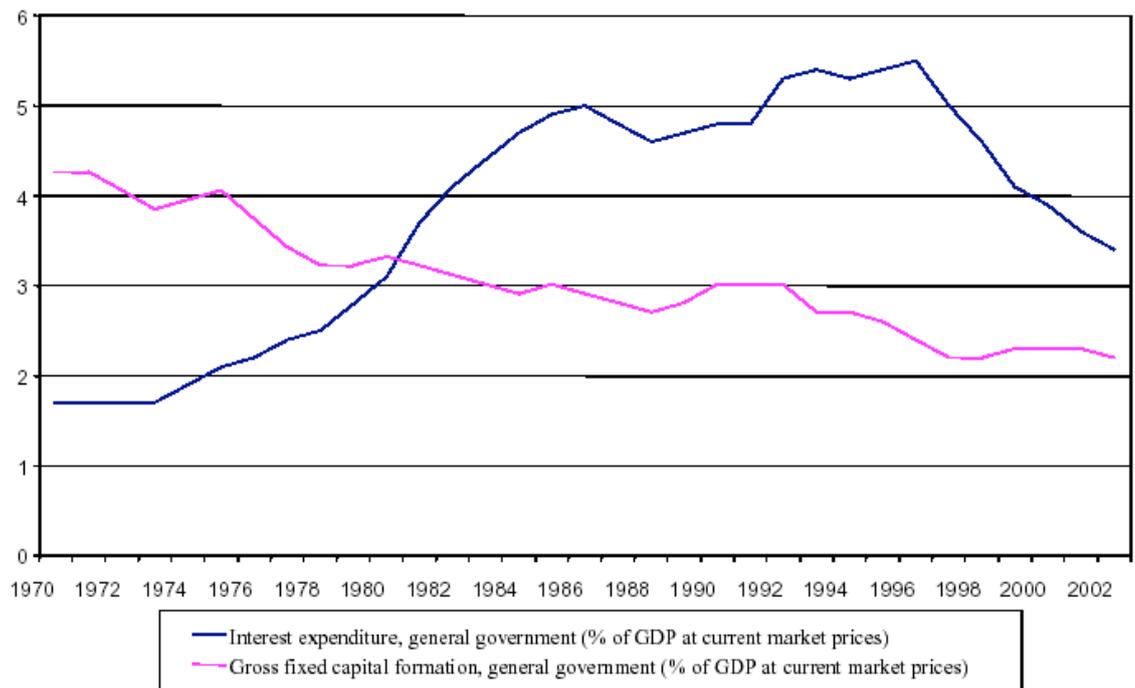
Source: Regling and Costello (2003,14).

Figure 8: Public investment changes in the 1990s (average yearly growth rate in gross fixed capital formation, general government, % of GDP at current market prices)



Source: Turrini (2004, 49)

Figure 9: Interest expenditure and public investment, EU-15, 1970-2002



Source: European Commission (2003, 87).

Appendix 2

Table 1: Economic indicators in the European Union in 1995 and the Maastricht Treaty convergence criteria (excluding the exchange rate criterion)

	Budget (1)	Debt (2)	Interest rate (3)	Inflation (4)
Belgium	-4.1	133.7	*** 7.5	*** 1.4
Denmark	# -1.6	71.9	8.3	2.3
Germany	-3.5	# 58.1	6.9	1.5
Greece	-9.1	111.8	17.4	9.0
Spain	-6.6	65.7	11.3	4.7
France	-4.8	# 52.8	7.5	1.7
Ireland	# -2.0	81.6	8.3	2.4
Italy	-7.1	124.9	12.2	5.4
Luxembourg	# 1.5	# 6.0	7.6	1.9
Netherlands	-4.0	79.7	** 6.9	** 1.1
Austria	-5.9	69.0	7.1	2.0
Portugal	-5.1	71.7	11.5	3.8
Finland	-5.2	# 59.2	* 8.8	* 1.0
Sweden	-8.1	78.7	10.2	2.9
United Kingdom	-5.8	# 54.1	8.3	3.1
EU-15	-5.0	71.3	8.9	3.0

Public deficit not exceeding 3% of GDP; Public debt not exceeding 60% of GDP.

*, **, *** First, second, and third best performer in terms of price stability.

(1) General government net lending (+) / net borrowing (-) as a percentage of GDP.

(2) General government gross debt.

(3) Long-term interest rate.

(4) Annual rates of inflation.

Source: adapted from European Monetary Institute (1996, IV).

Table 2: Budgetary developments in 1999 (% of GDP)

	Budget balance	Change in the balance from 1998	Of which change in:			Public debt	Change in debt
			Revenue	Primary expenditure	Interest expenditure		
B	-0.9	0.2	-0.1	0.2	-0.5	114.4	-3.0
D	-1.1	0.7	0.7	0.1	-0.1	61.0	0.3
E	-1.1	1.4	0.4	-0.4	-0.7	63.5	-1.4
F	-1.8	0.9	0.9	0.1	-0.2	58.6	-0.7
IRL	2.0	-0.1	0.7	1.8	-0.9	52.4	-3.2
I	-1.9	0.9	0.4	0.7	-1.3	114.9	-1.4
L	2.4	-0.9	-0.7	0.2	0.0	6.2	-0.3
NL	0.5	1.3	1.1	0.2	-0.4	63.6	-3.3
A	-2.0	0.4	-0.3	-0.5	-0.2	64.5	1.1
P	-2.0	0.1	2.9	2.9	-0.2	56.7	0.2
FIN	2.3	1.0	-0.3	-1.1	-0.2	47.1	-1.9
EUR-11	-1.2	0.8	0.6	0.2	-0.4	72.1	-0.9
DK	3.0	1.8	0.4	-0.7	-0.6	52.5	-3.3
EL	-1.6	1.5	1.5	0.3	-0.4	104.4	-1.0
S	1.9	0.0	-0.2	0.5	-0.7	65.5	-6.8
UK	1.2	0.9	-0.2	-0.4	-0.7	45.9	-2.5
EU-15	-0.6	0.9	0.4	0.1	-0.5	67.6	-1.4

Source: European Commission (2000, 30).

Table 3: Budgetary developments in 2000 ⁽¹⁾ (% of GDP)

	Actual budget balance 2000	Change in actual balance 99/00	Change in actual balance due to:			Change in primary balance due to:		Cyclically adjusted balance 2000	Government debt 2000
			Revenue	Primary expenditure	Interest expenditure	Cyclical comp. ⁽²⁾	Primary CAB ⁽³⁾		
B	0.0	0.7	-0.1	-0.5	-0.2	0.8	-0.3	-0.2	110.8
D	-1.0	0.4	-0.2	-0.3	-0.2	0.5	-0.3	-0.8	60.3
E	-0.4	0.7	-0.1	-0.5	-0.3	0.3	0.2	-0.8	60.7
F	-1.4	0.2	-0.5	-0.6	-0.1	0.2	-0.1	-1.4	58.0
IRL	4.5	2.4	-0.6	-2.7	-0.3	0.7	1.4	3.1	38.9
I	-1.5	0.2	-1.0	-1.0	-0.3	0.4	-0.4	-1.3	110.3
L	5.3	0.6	-0.8	-1.4	0.0	1.5	-0.9	4.3	5.3
NL	1.3	0.4	-0.2	-0.1	-0.5	0.4	-0.5	0.7	56.2
A	-1.5	0.6	-1.0	-1.6	0.0	0.2	0.4	-1.5	62.9
P	-1.7	0.4	0.5	0.2	-0.1	0.1	0.2	-2.1	54.1
FIN	6.7	4.9	1.5	-3.0	-0.3	1.0	3.6	5.1	44.0
EUR-11	-0.7	0.5	-0.4	-0.7	-0.2	0.4	-0.1	-0.7	69.9
DK	2.4	-0.6	-2.7	-1.6	-0.5	0.3	-1.4	1.8	46.3
EL	-0.9	0.9	0.5	-0.1	-0.3	0.3	0.3	-0.8	103.9
S	4.0	2.2	0.3	-1.3	-0.6	0.5	1.2	3.3	55.6
UK	1.9	0.6	0.7	0.3	-0.3	0.2	0.2	1.8	42.9
EU-15	0.0	0.6	-0.3	-0.6	-0.3	0.4	0.0	-0.1	64.6

⁽¹⁾ Excluding UMTS.⁽²⁾ Component of the primary balance affected by economic fluctuations.⁽³⁾ Primary CAB = cyclically-adjusted primary balance.

Source: European Commission (2001, 12).

Table 4: Euro-area budget deficits in 2000-2003, excluding UMTS proceeds (% of GDP)

	2000	2003	Change
(1) Budget deficit	-0.9	-2.7	-1.8
(2) Cyclically-adjusted deficit	-1.8	-2.1	-0.3
(3) C.A. primary balance	2.3	1.4	-0.9
Change in budget deficit (1) due to			
	Growth	Interest	Policy discretion
	(1)-(2)	(2)-(3)	(3)
2000-2003	-1.5	0.6	-0.9

Source: European Commission (2004, 24).

Table 5: Government debt ratio in EMU member states, 2002-2005 (% of GDP)

	Government debt				Change in Government debt 2003-05	Change in 2003-05 due to:		
	2002	2003	2004	2005		Primary balance	Interest & growth contribution	Stock flow adjustment
BE	105.8	100.5	97.4	94.3	-6.2	-8.7	2.5	0.1
DE	60.8	64.2	65.6	66.1	1.9	0.1	2.9	-1.1
EL	104.7	103.0	102.8	101.7	-1.3	-5.1	-2.7	6.6
ES	54.6	50.8	48.0	45.1	-5.7	-5.6	-1.5	1.4
FR	58.6	63.7*	64.6	65.6	2.6	1.2	1.5	0.0
IE	32.3	32.0	32.4	32.6	0.6	-0.9	-1.1	2.7
IT	108.0	106.2	106.0	106.0	-0.2	-3.0	2.3	0.5
LU	5.7	4.9	4.5	3.8	-1.1	4.1	-0.2	-5.0
NL	52.6	54.8	56.3	58.6	3.8	1.0	3.6	-0.8
AT	66.6	65.0	65.5	65.3	0.3	-3.1	1.8	1.7
PT	58.1	59.4	60.7	62.0	2.6	1.3	1.7	-0.3
FI	42.6	45.3	44.5	44.3	-0.9	-7.6	0.5	6.2
EUR-12	69.2	70.4	70.9	70.9	0.5	-1.5	1.7	0.2

Source: European Commission (2004, 18).

Table 6: Budget balances in EMU member states, 2000-2004 (% of GDP)

	Budget balance					Cyclically-adjusted budget balance					Cyclically-adjusted primary balance				
	2000 (1)	2001 (1)	2002	2003	2004	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
BE	-0,1	0,3	0,1	0,2	-0,5	-1,1	-0,4	0,1	0,7	0,0	5,7	6,2	6,2	6,3	5,1
DE	-1,3	-2,8	-3,5	-3,9	-3,6	-1,6	-3,0	-3,5	-3,2	-2,9	1,7	0,3	-0,4	0,0	0,1
EL	-0,8	-1,9	-1,4	-3,2	-3,2	-0,9	-2,3	-1,7	-3,6	-4,1	6,1	4,0	4,4	2,1	1,5
ES	-0,4	-0,1	0,0	0,3	0,4	-1,1	-0,8	-0,2	0,4	0,6	2,2	2,3	2,6	2,9	2,9
FR	-1,3	-1,6	-3,2	-4,1	-3,7	-1,7	-2,2	-3,8	-3,9	-3,4	1,6	0,9	-0,7	-0,8	-0,3
IE	4,5	1,2	-0,2*	0,2	-0,8	2,4	0,0	-1,9	0,1	-0,3	4,5	1,5	-0,5	1,5	1,1
IT	-1,7	-2,6	-2,3	-2,4	-3,2	-1,9	-3,1	-2,2	-1,9	-2,6	4,6	3,3	3,5	3,4	2,4
LU	5,8	6,4	2,7	-0,1	-2,0	4,2	4,1	2,7	1,3	0,6	4,5	4,4	2,9	1,5	0,8
NL	1,5	0,1	-1,9	-3,2	-3,5	-0,1	-1,0	-2,6	-2,0	-1,7	3,9	2,5	0,4	0,9	1,1
AT	-1,9	0,3	-0,2	-1,1	-1,1	-2,5	0,0	-0,3	-0,9	-0,9	1,2	3,5	3,1	2,2	2,3
PT	-1,8	-4,2	-2,7	-2,8	-3,4	-2,6	-4,6	-2,7	-1,8	-2,1	0,5	-1,5	0,3	1,1	0,8
FI	7,0	5,1	4,3	2,3	2,0	4,0	4,2	3,7	2,3	2,1	6,8	7,0	5,9	4,2	3,9
EUR-12	-0,8	-1,6	-2,3	-2,7	-2,7	-1,4	-2,1	-2,5	-2,2	-2,2	2,7	1,8	1,2	1,3	1,2

(1) excluding UMTS.

* Excluding UMTS receipts for Ireland in 2002.

Cyclically-adjusted figures are computed with the Production Function method, except for the whole year 2000, and for Germany, Spain, Luxembourg and Austria in 2001, and Germany, Spain and Austria in 2002-2004, where the Hodrick–Prescott (HP) filter method has been used.

Figures for 2000 and 2001 are not revisited.

Source: adapted from European Commission (2002, 11), (2003, 5), and (2004, 17).

Table 7: Estimates of cyclical safety margins and minimal benchmarks, 2002

	Revised estimates			Difference with previous estimates	
	Budgetary sensitivity	Cyclical safety margin	Minimal benchmark	Revised minimal benchmarks — 2000 estimates	Revised minimal benchmarks — 1998 estimates
B	0.60	2.3	-0.7	+0.1	+0.3
D	0.50	1.4	-1.6	-0.5	-0.5
EL	0.40	1.3	-1.7	-0.3	-0.3
E	0.40	1.5	-1.5	-0.1	-1.1
F	0.40	1.3	-1.7	-0.1	-0.2
IRL	0.35	1.7	-1.3	-0.1	-0.4
I	0.45	1.5	-1.5	+0.1	-0.3
L	0.60	3.1	0.1	+0.2	+0.1
NL	0.65	2.3	-0.7	-0.6	-0.6
A	0.30	0.9	-2.1	-0.1	-0.8
P	0.35	1.8	-1.2	+0.3	-0.6
FIN	0.70	3.8	0.8	+0.4	-0.5
EUR-12	0.50	1.6	-1.4	-0.2	-0.4
DK	0.80	2.7	-0.3	-0.5	+0.4
S	0.70	2.2	-0.8	-0.4	-1.6
UK	0.50	1.8	-1.2	-0.1	-1.1
EU-15	0.50	1.6	-1.4	-0.3	-0.6

Source: European Commission (2002, 60).

Table 8: Long-term debt to GDP ratio in EU-15 up to 2050

	2003	Programme scenario			2003 budget scenario		
		2010	2030	2050	2010	2030	2050
BE	102.3	74.8	11.5	-5.0	67.2	-35.7	-114.0
DK	42.7	24.6	-19.5	-34.8	6.9	-65.5	-131.9
DE	64.0	62.2	86.5	175.7	74.3	156.5	336.6
EL	101.7	75.1	42.2	151.0	72.2	52.4	181.0
ES	51.8	36.3	-1.6	36.6	31.6	-21.4	-12.4
FR	61.4	56.0	52.2	72.0	71.8	142.1	288.0
IE	33.1	26.7	36.4	105.0	27.0	50.1	138.4
IT	106.0	86.6	28.9	-27.8	92.0	82.7	107.8
LU	4.9	-0.9	-9.4	1.2	-3.9	-35.7	-47.8
NL	54.0	49.1	67.6	140.0	53.8	88.7	185.9
AT	66.4	53.9	24.4	15.9	55.1	26.1	18.4
PT	59.5	48.0	5.3	-42.4	60.9	72.1	127.6
FI*	-14.6	-33.4	-30.1	6.0	-52.8	-79.5	-88.6
SE*	33.0	16.4	-0.4	46.7	15.2	19.8	97.6
UK	39.3	42.5	71.6	138.7	45.3	89.5	177.5

* Adjusted gross debt, netting off the accumulated liquid financial assets.

Source: European Commission (2004, 69).

Table 9: A schematic representation of the proposals for reform of EU fiscal policy-making

	Domestic	International
Changes in procedures and rules	<p>(I)</p> <p>Expenditure Rules: Mills and Quinet (2001)</p> <p>Improving National Budgetary Process: von Hagen (2002)</p>	<p>(II)</p> <p>Debt Stability Pact: Pisani-Ferry (2002)</p> <p>Golden Rule: Blanchard and Giavazzi (2003)</p> <p>Permanent Balance: Buiters and Grafe (2003)</p> <p>Tradeable Deficit Permits: Casella (2001)</p> <p>Index of Institutional Reforms: Eichengreen (2003)</p> <p>Quality of Fiscal Policy: Beetsma and Debrun (2003)</p>
Changes in institutions	<p>(III)</p> <p>Fiscal Policy Committee: Wyplosz (2002) Calmfors (2003)</p> <p>Fiscal Regulator: Wren-Lewis (2002)</p>	<p>(IV)</p> <p>Sustainability Council: von Hagen (2003)</p>

Source: Jonung and Larch (2004, 26).