
STABILITY AND GROWTH IN EUROPE: TOWARDS A BETTER PACT

Monitoring European Integration 13

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The opinions expressed herein are those of the authors alone, and do not reflect the views of the institutions with which they are affiliated, nor of CEPR, which takes no institutional policy positions. The Centre is delighted, however, to provide the authors this forum for the analysis of an issue so critical for Europe's long-term economic health.

Preface

The European Union's Stability and Growth Pact (SGP) was adopted in 1997, with the intention of strengthening the Excessive Deficit Procedure already embodied in the Maastricht Treaty. It is intended to promote the sustainability of euro area public finances by restraining national governments from running up levels of debt that might threaten price stability in EMU, and, ultimately, the common currency itself. The appropriate design for a framework to ensure fiscal responsibility has proved contentious from the outset, and is now the subject of vociferous debate, in light of the deterioration in fiscal conditions in the euro area.

Indeed, a brief glance at the current state of several of the area's leading economies – among them France and Germany, the originator of the SGP – leaves no doubt that the preventive elements of the current Stability and Growth Pact have failed to contain budget deficits to the reference value of 3% of GDP. In the face of this, many are questioning whether numeric targets make economic sense at all, and whether the numerous proposals for reform would, in fact, address the weaknesses in the existing regime.

Such issues are ably taken up by a distinguished team of economists in this thirteenth title in CEPR's *Monitoring European Integration (MEI)* series, which presents a carefully structured framework, soundly based in economic theory, for assessing the current situation and benchmarking proposed solutions.

The authors critique the design of the Stability and Growth Pact, and assess its impact on budget discipline, growth, debt reduction and the sustainability of public finances since 1999. Their results show that the SGP has achieved little, if any, strengthening of fiscal discipline in EMU. Fiscal policies were generally expansionary even when growth was strong, and countries were thus not building up 'rainy day' funds to offset poor economic conditions in later downturns. They conclude that the euro area's poor fiscal performance to date is unsurprising, given the problems implicit in a framework for sustainability based on numerical values (which may create a conflict between a government's chosen policy and what is in the best interests of the euro area as a whole) and weak enforcement.

The Report finds that current reform proposals do not solve the problems of such a rules-based framework for the essential reason that a proper assessment of sustainability requires the use of judgment in evaluating the quality of public finances and their consequences for the growth prospects of the economy. Rather, the authors advocate moving from a rules-based system to one incorporating expert judgment. They propose a Sustainability Council for the euro area, with a mandate to safeguard the sustainability of public finances - a sort of fiscal analogue to the European Central Bank (minus the policy role) - and explain how such a body could overcome the main drawbacks with the current system.

The *Monitoring European Integration* series is intended to provide timely analysis of important economic policy issues of concern to Europe. Reports aim both to furnish a coherent economic framework, against which all interested

parties may critically evaluate the various positions in the debate, and to express the opinions and recommendations of Europe's top economists. This Report amply fulfills these objectives. It is to be hoped that the valuable analysis and bold ideas set forth will lead to significant improvements in the institutions and mechanisms employed in the oversight of euro area fiscal policy-making.

Hilary Beech
Chief Executive Officer

September 2003

Executive Summary

Our initial assessment

Since the start of economic and monetary union (EMU), fiscal conditions in the member states have slipped considerably. The fiscal policy framework of EMU is in a state of crisis and it is clear that the preventative arm of the SGP, which should preclude excessive deficits in the member states, has failed.

This failure is the result of the problems inherent in a framework focusing on numerical values and lacking strong enforcement.

There is a need for reform

Even though the current framework has obvious weaknesses, further erosion of European fiscal institutions is undesirable. Current developments, however, indicate that it is likely unless the EU undertakes a serious reform of its fiscal framework.

There is no shortage of proposals for reform. They range from calls for more sophisticated fiscal rules and changes in the implementation of the current framework and the institutional governance of fiscal policy in EMU, to calls for outright abandonment of the fiscal limits of the Maastricht Treaty and the Stability and Growth Pact.

We argue that these proposals offer no solution to the problems and limitations of a framework based on numerical rules to achieve sustainability.

We advocate instead the use of living bodies, an institutional framework allowing for informed and credible judgement in the short run while preserving sustainable public finances in the long run.

Our proposal recognizes that...

...the stability of the common currency needs an appropriate framework for fiscal policy to maintain the sustainability of public finances.

The original institutional setting adopted by the Maastricht Treaty provides a viable basis for amending existing procedures.

The link between fiscal policies and the sustainability of public finances goes far beyond the effect of annual budget deficits on public debt. It includes in particular the consequences of the quality of fiscal policies for economic growth in the short and the long run.

The challenge in designing a fiscal framework for EMU is in finding an appropriate translation of the long-run concern for sustainability to the short-run behaviour of the government and an effective enforcement mechanism. This requires informed and credible judgement rather than adherence to numerical rules.

The use of living bodies allowing for judgement in the short run while preserving sustainable public finances in the long run is the right direction of reform.

A Sustainability Council for the euro area

Implementing a judgemental approach while improving the credibility of the system must be guided by the principles of independence, accountability and transparency to be effective. These principles set the benchmark against which the institutional design has to be assessed.

Based on these principles, we propose the creation of a Sustainability Council for the euro area, an independent panel of experts with a clear mandate, a credible enforcement mechanism, and a well-designed procedural setting guaranteeing independence and accountability at the same time.

The Sustainability Council has the sole statutory task of safeguarding the sustainability of public finances in the euro area. The national governments would have to submit their annual and medium-term fiscal plans to the Sustainability Council, which would judge the compatibility of the implied change in general government debt with sustainability.

This mandate is the counterpart of the European Central Bank's principal task of maintaining price stability. In contrast to the ECB, however, the Sustainability Council has no operative role in fiscal policy. It does not set taxes nor public expenditures. The use of the instruments of fiscal policy is entirely left to the national governments.

The Sustainability Council would have the right to make its judgement fully public. It would declare a member state in excessive deficit if it came to the conclusion that it is not compatible with sustainability. It would have the sole right to recommend the imposition of financial fines on member states to the ECOFIN Council, which would have to vote on this proposal.

As a European institution, the Sustainability Council must rely mainly on political pressures generated through public opinion and financial markets to enforce fiscal discipline effectively in large and small member states alike. The reliance on public opinion ensures that the Sustainability Council must safeguard its own reputation of high-level expertise and fair judgement.

The Sustainability Council would be composed of fiscal experts. The independence and legitimacy of these experts should be based on a nomination process involving the European Parliament. Dismissal of the Sustainability Council would be possible only collectively.

The advantages of our proposal

Replacing rigid rules by judgemental assessment of the fiscal situation and outlook of each euro-area member state can take into account all relevant aspects of the situation. This makes room for more flexible fiscal policies in the short run.

Entrusting the analysis and judgement of sustainability to an independent, transparent and accountable institution strengthens the credibility of the framework. It thus provides an adequate basis to affect the opinion of the relevant public on a country's state of public finances.

In contrast to more sophisticated numerical rules, the Sustainability Council combines more flexibility of fiscal policy with greater credibility. It sets a benchmark for reform proposals of the fiscal framework of EMU. Any reform should follow the basic principle of wedding flexibility with credibility.

1 The Stability and Growth Pact – Design and Recent Experiences

1.1 Europe's fiscal framework under stress

Since the start of EMU, fiscal conditions in the member states have slipped considerably. On average, general government balances deteriorated from a slight surplus in 2000, a year of unusually strong economic growth,¹ to a deficit of 2.2% of GDP in 2002. Further worsening is expected in 2003. Individual performances especially for the large EMU economies are even worse than this average suggests. Germany's general government balance fell from a deficit of 1.4% of GDP in 2000 to a deficit of 3.6% in 2002. In France, the general government deficit rose from 1.4% of GDP in 2000 to 3.2% in 2002; in Italy, it rose from 1.8% to 2.3% of GDP. Portugal recorded a deficit of 4.2% of GDP in 2001. These developments cannot be attributed solely to the economic slowdown in Europe and the world economy and the effects of automatic fiscal stabilizers. Between 2000 and 2002, cyclically adjusted budget deficits moved from 1.9% of GDP to 3.3% in Germany, from 2.1% to 3.3% in France, and from 2.4% to 2.1% in Italy.²

It is also obvious that the fiscal policy framework of EMU is in a state of crisis. The preventative arm of the Stability and Growth Pact, which should preclude excessive deficits in the member states, has evidently failed. In January 2002, the European Commission recommended to ECOFIN that it should issue early warnings against Germany and Portugal, as both countries exceeded their deficit targets under their Stability Programmes and ran the risk of having excessive deficits. However, ECOFIN decided against this, accepting Germany's promise to correct the deficit during the year. During the spring and early summer of 2002 France and Italy declared their intentions to postpone the goal of balancing their budgets by several years. By making the achievement of a close-to-balance position for France conditional on unrealistically high growth forecasts, ECOFIN accommodated the French decision in June. In July, the Portuguese government reported that its deficit in 2001 was 4.1% of GDP.

In September, the European Commission announced a new strategy on balanced budgets, giving governments until 2006 to achieve budget balance. On 8 October, the Finance Ministers of the euro group countries, except France, declared instead their commitment to start balancing their budgets immediately. They committed all countries that had not reached budget balance to reduce

1 European Commission (2003, p. 5).

2 European Commission (2002, 2003) and European Commission, *Cyclical Adjustment of Budget Balances*, Autumn 2002.
http://europa.eu.int/comm/economy_finance/indicators/generalgovernmentdata_en.htm

their cyclically adjusted deficits annually by at least 0.5% of GDP starting in 2003. However, they did not adopt a final date for reaching a budget position close to balance or in surplus. On 17 October, a day after the formal opening of an Excessive Deficit Procedure against Portugal, the president of the European Commission publicly called a strict interpretation of the Stability and Growth Pact 'stupid'.

Soon after the German federal elections in September, the German government revealed its inability to stay below the 3% deficit limit in 2002. The Commission adopted the view that Germany had an excessive deficit on 19 November, and ECOFIN followed its proposal in January 2003. Soon after the spring tax estimates in May 2003, Germany's finance minister Hans Eichel indicated that Germany would breach the 3% deficit limit again in 2003, and that Germany would not be able to reach a balanced budget by 2006. Nevertheless, Commissioner Pedro Solbes, in a speech on 21 May, indicated his satisfaction with the German government's measures to correct the deficit, although the fiscal impact of these measures is still highly uncertain. Soon afterwards, on 13 June, the minister of economics, Wolfgang Clement, rather than the finance minister, set the year 2008 as a new target date for achieving budget balance in Germany. With the proposal to pull forward a tax reform originally planned for 2005, the German federal government showed that it did not regard the fiscal limits set by the Maastricht Treaty as a binding constraint.

At its January 2003 meeting, ECOFIN also issued an early warning against France. ECOFIN decided that an excessive deficit existed in France on 3 June 2003. In its recommendation, however, ECOFIN gave the French government until 2004 to adopt measures correcting the cyclically adjusted deficit by at least 0.5% of GDP. Noting that this was not consistent with the Euro group's commitment of the previous October, the Dutch government declared that it did not support that recommendation. In mid-July, the French government announced that it was going to breach the deficit limit of the SGP for the third time in 2004. Immediately afterwards, the French president, Jacques Chirac, called for a temporary softening of the Pact, asking for a better compromise between stability and economic growth and a solution that would take the individual circumstances of each country into account. Solbes rejected that idea, affirming that there was no need to reform the SGP.

Since the start of this string of events, there has been no scarcity of proposals for reforming the EMU fiscal framework. The European Commission has offered its views on reforms; the European Parliament has held hearings on the issue; policy-makers and academics have presented numerous proposals for improvements. The views presented range from calls for abandoning outright the fiscal limits of the current framework to calls for a hardening of the fiscal rules, for tighter fiscal policy coordination, for changes in the implementation of the current framework, and for changes in the institutional governance of fiscal policy in EMU.

This study seeks to contribute to the ongoing debate on the future fiscal framework of EMU. We start by clarifying the issues involved in this debate, review some of the existing proposals for reform and develop our own proposal for a better fiscal framework of the monetary union.

In our view, the key feature of a fiscal framework for EMU is how it links the union's legitimate interest in the sustainability of the member states' public finances with the conduct of fiscal policy in these states on an annual basis.

This linkage is critical, because sustainability is a long-run concern with few implications for the actual course of government spending, revenues and deficits in the short run. The Maastricht Treaty and, even more so, the SGP, seek to provide this link by subjecting the member states to numerical limits concerning their deficits and debts. The problem with such limits is twofold. First, they interfere with what governments might perceive to be optimal fiscal policies in the short run, creating a conflict between what is deemed desirable for the monetary union as a whole and what is deemed desirable from the perspective of the national government. Second, violating these limits in any given year may have no obvious implications for the stability of the common currency. This implies that imposing harsh fiscal restraint on EMU member states will often seem quite unnecessary.

The art of designing a fiscal framework for EMU is in finding an appropriate translation of the long-run concern for sustainability to the short-run behaviour of the government and an effective enforcement mechanism. We are convinced that *dead rules* based on simple numerical criteria cannot provide this link properly. More sophisticated rules, however, are open to manipulation and political games. Instead, we advocate the use of *living bodies*, that is, an institutional framework that allows for judgement in the short run while preserving sustainable public finances in the long run.

This study proceeds as follows. In the remainder of this chapter, we review the arguments for a fiscal framework in a monetary union and the current framework prevailing under EMU. Chapter 2 provides some theoretical background for our arguments, exploring the tension between the long-run oriented concept of sustainability and the more short-run notion of optimal fiscal policies. Chapter 3 gives an account of the experiences with the European fiscal framework so far. Chapter 4 develops our discussion of *dead rules* versus *living bodies* as alternative approaches to preserving sustainability. On this basis, Chapter 5 presents our proposal for a new institution, which we call the European Sustainability Council, designed to make *living bodies* effective. We discuss alternative, perhaps politically more realistic arrangements and their drawbacks compared with the European Sustainability Council in the concluding chapter.

1.2 Sustainability: why EMU needs a fiscal framework

A basic belief underlying the framework of EMU is that the stability of the common currency requires the stability of public finances. The fear that high and rising public debts would undermine the central bank's ability to deliver price stability has left its mark in all important documents and political decisions on the way to EMU.³ In terms of technical economic analysis, fiscal policy and monetary policy are indeed linked through the 'intertemporal budget constraint', the requirement that in the long run the discounted sum of a government's expected expenditures cannot exceed the discounted sum of its

3 Although the post-World War II inflations in the industrialized countries were not caused by excessive public debts, the fear derives from disastrous historical experience, namely the hyperinflations in Germany and Austria of the early 1920s and the German currency reform of 1948.

expected revenues.⁴ If the government can print money, seignorage is part of its expected revenues. Thus, given an expected stream of expenditures in the future, and given an expected stream of tax revenues, seignorage has to make due for any shortfall of the latter over the former. As closing the gap requires printing more money, inflation will be the consequence.

In EMU, the issue is somewhat more complicated, because the governments of the individual member states have given up the right to print money. Seignorage is paid to them in the form of central bank profits. But since the European Central Bank (ECB) is politically independent, by virtue of the Treaty on European Union (Art. 104 TEU and Art. 21.1 of the ECB Statutes) it cannot directly monetize public debts. Consequently, seignorage should not be responsive to government spending and tax policies. The governments must, therefore, adjust taxes and expenditures to ensure that the intertemporal budget constraint holds; otherwise they would be forced at some point to default on their debts. A fiscal crisis would arise, but it would not create inflation in EMU, unless the ECB ignored its mandate for price stability and offered financial relief for the troubled governments. Although the ECB cannot legally bail out a distressed government by buying its debt directly, it can offer financial relief indirectly. A bailout could occur *ex post*, with the central bank buying up large amounts of government debt in the secondary market, or *ex ante*, with the central bank holding down interest rates to reduce the government's interest payments.⁵ Either way, the critical question is, whether or not the central bank's institutional independence and its will to safeguard price stability are sufficiently strong to withstand all political pressures to provide a bailout.

A second consideration in EMU is that the inflation caused by a bailout is spread over the entire monetary area and, *ceteris paribus*, is lower for the government demanding a bailout than it would be if that government still issued its own currency. Thus, EMU reduces the inflation cost of a bailout of a given size, and excessive public debts create negative externalities for the citizens of other countries, if the ECB provides a bailout. This means that the incentives for national governments to maintain stable public finances are weaker in EMU than in national monetary systems. Unless there is complete certainty that the ECB never provides a bailout, one should, therefore, expect that fiscal policy is less disciplined in EMU (Beetsma, 2001).

Both considerations lead to the conclusion that EMU requires institutional constraints preventing the national governments from running up excessive levels of debt that would, in the long run, threaten price stability in EMU, and, with that, EMU itself. The difficulty with that conclusion is in the question of how to translate it into a framework that guides and constrains the governments' fiscal policies in the short run. As noted above, the governments' intertemporal budget constraint pertains to the long run. Therefore, it has little, if any, implications for annual budgetary policies and fiscal flows.⁶ A year or even a short sequence of years with large deficits and rising public debt does not *per se* imply a violation of the intertemporal budget constraint, if a corresponding fall in expenditures or rise in revenues can be expected in the future.

4 See e.g. Sargent and Wallace (1981).

5 The Maastricht Treaty (Art. 101) and the Statute of the European System of Central Banks (ESCB) prohibit central bank purchases of government debt in the primary market. In contrast, operations in the secondary market are allowed.

6 This is best seen in the fact that governments can always promise future actions to collect more revenues to compensate for today's deficits. See Perotti et al. (1998) for a more detailed discussion.

Thus it is hard, both politically and economically, to justify fiscal retrenchment in any given period with the need to maintain sustainable public finances. Adjustment can always be promised for future periods, and there is always hope for better times in the future. Obviously, this is true in times of weak economic performance even more than in times of a strong macroeconomy.

In a world with perfect information and no transactions costs, the optimal solution to this problem would be to adopt an *ex-ante* optimal fiscal policy rule, that is, one that states in detail what governments should do under what circumstances to meet the intertemporal budget constraint. Such a rule could accommodate periods of slow economic growth by easing fiscal policy and compensate with greater restraint in periods of strong growth. It could, therefore, accommodate fiscal expansions in some periods by distributing the required adjustment over subsequent periods. In reality, however, the world is too complex and uncertain to do that. There are too many circumstances that cannot be anticipated *ex ante*. And even if all future contingencies were known, verifying the realized state of the world would be difficult. Thus, the enforceability of such a rule is doubtful.

What about the alternative of imposing a simple fiscal rule limiting annual government deficits or debts? We argue that such a rule is of little use, because it would be perceived as constraining the governments' fiscal policies either too much or too little in most short-run circumstances. Either way, it would lack credibility: in the first case, because it may force sovereign governments under some circumstances to adopt policies that are otherwise unreasonable or even damaging for their own countries; and in the second case, because it would not bind government actions sufficiently in the short run.

This reasoning leads us to conclude that fiscal rules are not the proper response to the challenge of maintaining the intertemporal budget constraint in a monetary union. The alternative is to design a framework that combines guidelines for short-run budgetary policies with proper judgement about current and future developments.

1.3 The fiscal framework of EMU

The need for a genuine institutional framework to deal with the exceptional degree of fiscal decentralization in a monetary area prevailing in EMU was already recognized in the blueprint for monetary union in Europe, the Delors Report (1989). Building on its predecessor, the Werner Report (1970),⁷ the Delors Report called for institutional provisions safeguarding fiscal discipline in EMU, arguing that a lack of fiscal discipline might undermine the stability of the new currency.⁸

7 The Werner Report, published in 1970, was the first document outlining the creation of a monetary union among the member states of the European Communities after the adoption of this goal by the European Summit of The Hague in 1969.

8 Furthermore, the Delors Report argued that the fiscal policies of the member states needed to be coordinated to assure a smooth macroeconomic functioning of EMU, and that there should be some degree of fiscal equalization among the members transferring public resources from member states in cyclical upswings to those in cyclical downswings.

EMU has developed an elaborate fiscal framework for this purpose. According to Art. 4(3) of the Treaty on European Union (TEU), 'sound public finances' are one of the guiding principles of economic policy in the EU. EU Procedures with relevance to the conduct and coordination of fiscal policy are the Mutual Surveillance Procedure (Art. 99), the 'no-bailout clause' (Art. 103), the Excessive Deficit Procedure (EDP, Art. 104), and the SGP (SGP, Council Regulations 1466/97, 1476/97, Council Resolution 97/C236/01-02). Article 99 holds that the member states of the EU regard their economic policies as a matter of common concern and coordinate them through the ECOFIN Council and on the basis of 'Broad Economic Guidelines'. The no-bailout clause protects the Community and the member states from becoming responsible for financial liabilities of other member states against their will. The EDP sets up a detailed process of monitoring the public finances of the member states with a view to ensuring that they remain sustainable. It includes the mandate (Art. 3 of the Protocol) that the member states of EMU should implement appropriate institutions at the national level that enable them to fulfil their obligation for maintaining sustainable public finances. There is, however, no explanation of what this obligation means in practice. The SGP refines and concretizes the procedures of the EDP.

1.3.1 The Excessive Deficit Procedure

The EDP is the cornerstone of the fiscal framework of EMU. It combines the unconditional obligation on the part of the member states to avoid 'excessive deficits' with a procedure aiming at providing a regular assessment of fiscal policies in EMU and identifying excessive deficits and, if necessary, penalties for profligate behaviour (Art. 104 TEU). The EDP charges the European Commission with the task of monitoring budgetary developments and the stock of public sector debt of the member states, checking in particular their compliance with two *reference values* for the ratio of the deficit to GDP and the ratio of public debt to GDP. The two reference values are set at 3% and 60%, respectively (Protocol on the EDP). If a member state does not comply with these reference values, and unless the deficit and the debt are approaching their reference values in a satisfactory way, and unless the excess of the deficit over the limit is exceptional and temporary, the Commission prepares a report to the European Council. This report takes into account whether the deficit exceeds public investment spending and 'all other relevant factors, including the medium term economic and budgetary position' (Art. 104(3)) of the country concerned. The Economic and Financial Committee (EFC), which advises the Council in these matters (Art. 114), then gives its opinion of this report. Note that, according to Art. 104(3), the Commission may also prepare a report to that effect, even if a member state complies with the criteria, but the Commission sees the risk of an excessive deficit nevertheless.

If the Commission considers that an excessive deficit exists, it expresses this opinion to ECOFIN and makes a recommendation for the Council to decide that an excessive deficit indeed exists.⁹ ECOFIN votes on this recommendation by qualified majority after taking into account any observations the country

9 Note that the Council acts upon a recommendation, not a proposal of the Commission. The significance is that the Council can change the content of the recommendation by qualified majority, while it can change the content of a proposal only by unanimity. See Italianer (1997).

concerned may make and after a broad assessment of the situation. Thus, ECOFIN decides whether or not an excessive deficit indeed exists.

If ECOFIN decides that this is the case, it makes confidential recommendations to the country concerned on how to correct the situation within a given period of time. If the country does not take appropriate action and does not respond to these recommendations in a satisfactory way, the Council may make its views and recommendations public, ask the government concerned to take specific corrective actions and, ultimately, fine the country. In that case, the country would first be required to make a non-interest bearing deposit with the Community. If the excessive deficit still persists, this deposit would be turned into a fine paid to the Community.¹⁰ ECOFIN can abrogate its decisions under the EDP upon a recommendation from the Commission. All ECOFIN decisions in this context are made by qualified majority; once a country has been found to have an excessive deficit, its votes are not counted in these decisions.

In the context of the EDP, then, the numerical reference values for deficits and debts serve as triggers for an assessment prepared by the European Commission and a judgement made by ECOFIN. They do not themselves define what an excessive deficit is, nor does breaching them imply any sanctions *per se* (Italianer, 1997). Since they merely serve as triggers for a more precise assessment of the situation, there is no need to make the criteria themselves responsive to economic circumstances, for example by redefining them to exclude interest spending or cyclical effects on spending and revenues. These and other circumstances can be accounted for in the Commission's analysis, EFC's opinion, and ECOFIN's broad assessment and final judgement. In view of the need to balance long-term objectives with short-run constraints on actual policy, such a trigger role is appropriate for the numerical criteria.

Yet the European public has never regarded the EDP as a credible protection of the euro against profligate fiscal behaviour. It lacks credibility because it is the finance ministers in ECOFIN who pass the ultimate judgement on whether or not excessive deficits exist and who adjudicate the penalties. By assigning these rights to ECOFIN, the EDP effectively makes a group of 'sinners' judge the performance of fellow 'sinners'. Considering the fiscal performance of other governments, ECOFIN members have every reason to accept excuses for weak discipline and the tendency to base future fiscal outlooks on overly optimistic economic assumptions. Being lenient and avoiding actions that are politically costly for fellow members is a rational strategy for ECOFIN members who might be in a position of fiscal distress in the future. This makes serious judgement and a strict application of the sanctions unlikely.

1.3.2 The Stability and Growth Pact

During the mid-1990s, public fears arose in Germany that the EDP would not suffice to discipline fiscal policies effectively in EMU. Germany's finance minister at the time, Waigel, responded to these fears by proposing a 'Stability Pact' for EMU, which was later adopted as the 'Stability and Growth Pact' (SGP) by the European Council.¹¹ The SGP modifies the EDP in several ways.¹² First, it

10 Note that neither the deposit nor its conversion into a fine affects the budget of the country in question as both are financial transactions.

11 For an account of the genesis of the SGP see Stark (2001).

12 See e.g. Costello (2001).

commits the member states to the medium-term objective of achieving budgets 'close to balance or in surplus'. This is a more specific goal than avoiding excessive deficits and a more ambitious one than the reference value for deficits under the EDP.

Second, it sets up an early warning system strengthening the surveillance of the public finances of member states. Under the SGP, EMU member states submit annual Stability Programmes to the European Commission and ECOFIN explaining their intended fiscal policies and, in particular, what they plan to do to reach and maintain the medium-term objective. Stability Programmes include annual fiscal targets as well as an explanation of the main economic assumptions underlying them. Implementation of these programmes is subject to the scrutiny of ECOFIN, which assesses whether the programmes are conducive to achieving the medium-term objective, whether they leave a sufficient safety margin to avoid excessive deficits, and whether the economic assumptions are realistic. Based on information and assessments by the European Commission and the EFC, ECOFIN can issue early warnings to countries that risk having an excessive deficit and significantly deviate from the fiscal targets set out in their Stability Programmes.

Third, the SGP gives more specific content to the notions of exceptional and temporary breaches of the 3% deficit limit.¹³ In doing so, it implicitly defines an excessive deficit based on the 3% reference value, implying that governments must unconditionally avoid deficits above 3% of GDP.¹⁴ Furthermore, the SGP clarifies the rules for financial penalties and speeds up the process by setting specific deadlines for the individual steps. Fourth, the SGP gives political guidance to the parties involved in the EDP, calling them to implement the rules of the EDP effectively and in good time. It commits the Commission, in particular, to using its right of initiative under the EDP 'in a manner that facilitates the strict, timely, and effective functioning of the SGP'. This puts severe limits on the Commission's right to exercise judgement on each individual case and situation, shifting that right to the Council instead.

The rules of the SGP have been further developed in a set of ECOFIN decisions regarding the format and content of the Stability Programmes.¹⁵ In October 1998, ECOFIN endorsed a Monetary Committee (the precursor of the Monetary and Financial Committee) opinion, the 'code of conduct' specifying criteria to be observed in the assessment of a country's medium-term budgetary

13 According to the SGP, breaching the reference value for deficits is justified by a severe economic downturn, if real GDP declines by 2%, or if it declines by at least 0.75% and additional evidence for the severity of the crisis exists. The SGP is much less clear on what is an 'unusual event outside the direct control of the Member State concerned and which has a major impact on the financial position of general government', which could also justify breaching the reference value (Council Resolution 97/C236/01, Council Regulation 1467/97, Art. 2). However, the original intention was clearly that such circumstances should almost never apply.

14 This new interpretation of the reference value is reflected in numerous statements from the Commission. For example, Cabral (1998, p. 26) argues that 'a government deficit above 3% of GDP is not excessive if the excess over 3% is only exceptional and temporary and the (government deficit) ratio remains close to the reference value', suggesting that it is excessive otherwise. Similarly, after noting that the three qualifications of exceptional, temporary and close to the reference value apply in a cumulative way, Costello (2001, p. 120) argues that 'consequently, nearly all breaches will de facto lead to a decision on the existence of an excessive deficit as the Commission and the Council have no grounds to decide otherwise'. See also European Commission (2002c, p. 7).

15 See European Commission (2002a, p. 23).

position, and data standards and requirements for the programmes. In October 1999, ECOFIN recommended stricter compliance with, and more timely updating of, the programmes. In July 2001, ECOFIN endorsed an appended code of conduct proposed by the EFC refining the format and the use of data in the Stability Programmes, including the use of a common set of assumptions about economic developments outside the EMU. Meanwhile, the Commission (2000) has specified a detailed framework of interpretation for the divergences from the targets set in the Stability Programmes.

Compared with the original EDP, the SGP has achieved two things. First, it shifts the nature of the fiscal framework significantly towards a rules-based concept constraining annual deficits and away from a framework based on informed judgement. Second, it weakens the position of the European Commission in the process, to the benefit of ECOFIN. While the Maastricht Treaty gave the Commission considerable discretion in initiating the EDP and moving it forward, the SGP, by making the process 'more automatic', reduces the Commission's role and raises the importance of ECOFIN judgements and decisions. Thus, the SGP shifts the balance of power in the fiscal policy framework from the institutional guardian of the Treaty, the Commission, to the representatives of the member state governments. As a result, the process and the decisions taken under it have become more politicized.

The combination of the EDP and the SGP has completely changed the role of the numerical reference value for the annual deficits from a trigger of an assessment process into a 'binding constraint', any breaching of which 'requires swift corrective action of the Member State concerned' and the 'timely activation of the Excessive Deficit Procedure' (Solbes, 2002a). Two factors have advanced this development. The first is the lack of credibility of the procedure, a problem already for the EDP, which became more severe due to the increase in the importance of ECOFIN's decisions under the SGP. Anticipating that the finance ministers will tend to accept each other's excuses for fiscal laxity, the European public and the media have put increasing attention and emphasis on the numerical criteria. The second factor is that the Commission has promoted the interpretation of the fiscal framework of EMU as a 'set of common fiscal rules' (Brunila et al., 2001, p. 1) centred on the numerical criteria. From the Commission's perspective, such an interpretation assures that the fiscal framework is applied equally to all member countries, and it conforms to the Commission's general role as the institution watching over the proper implementation of EU law.¹⁶ As a result, however, the nature of the fiscal framework has been transformed from a procedure ruled by oversight and informed judgement as foreseen by the Maastricht Treaty into a rigid numerical rule for the annual budget deficit.

16 See e.g. Solbes (2002b), European Commission (2002c, p. 22).

2 Sustainability and Optimality of Public Finances

2.1 Introduction

The primary reason for the EU to oversee and regulate the fiscal policies of its member nations is to ensure that their public finances are sustainable. A single nation's actual or threatened insolvency might jeopardize the area-wide financial system or destabilize the common currency by forcing the ECB into a bailout.

In this chapter, we explain more precisely what is meant by sustainable public finances and how sustainability relates to the optimality of fiscal policies in a broader sense. We start by discussing the concept of sustainability, why it may require a European framework to achieve sustainability, and whether the European fiscal framework is appropriate to achieve this objective. Next, we consider whether it is always desirable to stick to a rules-based framework geared towards compliance with annual deficit targets. We show that tensions between such a framework and optimal public finances may indeed arise. We then discuss whether externalities other than those arising from unsustainable public finances may justify a rules-based European fiscal framework; or whether such a framework may be in the interest of member states whose fiscal policy is sub-optimal. We do not, however, find the arguments for the fiscal constraints made on this basis convincing.

2.2 Sustainable public finances

We begin by discussing the requirements for sustainable public finances. Each period, the government's budget constraint requires that its current spending on goods and services plus the cost of servicing its current debt equals its current tax revenues plus the issuance of new debt. To illustrate this, assume that government borrowing is in the form of one-period bonds that pay an interest rate $i_t > 0$ in period t . Let G_t be the euro amount of government spending in period t , T_t be the euro amount of tax revenues in period t and B_t be the amount of euro-denominated debt issued in period t . Then, the government's period- t budget constraint can be written as:¹

$$G_t + (1 + i_t)B_{t-1} = T_t + B_t \quad (2.1)$$

1 For a detailed treatment of fiscal arithmetic in the context of the SGP see Buiter and Grafe (2002).

Let g_t , τ_t and b_t be the period- t ratios of government spending, tax revenues and debt issuance to GDP, respectively. Then equation (2.1) can be rewritten as

$$d_t + \frac{1+i_t}{1+\gamma_t} b_{t-1} = b_t, \quad (2.2)$$

where $d_t = g_t - \tau_t$ is the primary budget deficit and γ_t is the growth rate of nominal GDP. Equation (2.2) links the two key variables in the Excessive Deficit Procedure, the debt ratio and the deficit ratio. It says that the debt ratio increases if the nominal interest rate exceeds the nominal GDP growth rate and if the government runs a deficit.

A government cannot run a Ponzi game, that is, it cannot let its debt grow forever in an explosive fashion while satisfying its within-period budget constraint by issuing ever-increasing amounts of new debt to pay off the old plus the interest. The economic interpretation is that, calculated over all future periods, the present discounted value of the government's stock of debt must be zero.² Algebraically, this can be expressed as:

$$\lim_{t \rightarrow \infty} \left(b_t \prod_{s=1}^t \frac{1+\gamma_s}{1+i_s} \right) = 0 \quad (2.3)$$

If the current period is $t = 0$, then equations (2.2) and (2.3) imply

$$\sum_{t=1}^{\infty} (d_t \prod_{s=1}^t \frac{1+\gamma_s}{1+i_s}) + b_0 = 0, \quad (2.4)$$

where b_0 is the current debt-to-GDP ratio. Equation (2.4) expresses the government's intertemporal budget constraint and provides the condition that must be met for a fiscal policy to be sustainable. It says that the present discounted value of the stream of primary government deficits plus the value of current debt must equal zero. Note that running sizeable fiscal deficits over long periods of time is consistent with sustainability, as long as these deficits are compensated by large enough fiscal surpluses in the future.

Why is an EU regulation necessary to ensure that a country satisfies sustainability? Would a government ever deliberately risk insolvency without such a regulation? Perhaps the most convincing argument for why a rational government is excessively likely to become insolvent is that, once in economic difficulty, governments have an incentive to delay the necessary reform or stabilization.

As an example of how this might come about, suppose that a government has experienced an unfavourable economic shock and has begun to run unsustainable deficits. As the situation continues, the welfare loss associated with the cost of future taxes or expenditure cuts rises. If it continues long enough, the likelihood of insolvency becomes non-negligible. As a result, there is a consensus that the deficit should be reduced, but legislation that increases taxes or reduces expenditures may require the cooperation of the opposition political party. With perfect information about the costs to the opposition of possible reform

2 If the expression in equation (2.3) is strictly negative it means the government is accumulating surpluses in the long run; this is sub-optimal and we assume it does not occur.

packages, agreement could be reached immediately, with the government making the required concessions. The costs, however, are only known to the opposition. This may give the government an incentive to make uncompromising offers initially to distinguish between instances when it must make large concessions and those where it needs to concede little. The opposition then delays cooperation to signal that a particular reform plan is especially odious to them and that they require significant concessions.³

Given that governments may not act to minimize the risk of insolvency, a system of European-wide constraints on their behaviour may be desirable. A problem with designing a system of constraints, however, is that there are several practical accounting and forecasting problems associated with assessing whether or not a government is in compliance and whether or not this will lead to it satisfying the long-run budget constraint. The existence of off-budget and contingent assets and liabilities (such as the revenues and claims on state pension funds) complicates the calculation of the true financial position of member governments. Collecting and assessing budgetary statistics has proved to be a daunting task. The recent upward revisions of budget deficits in several EU countries, most notably Portugal, are an example of this. Even if inflation is stable, the difficulty in forecasting the real interest rate makes it hard to forecast the path of the nominal interest rate. The future growth of nominal GDP is difficult to project and varies across countries. The composition of government spending has implications for future deficits that are difficult to assess; for example, one must predict both the depreciation of and the return on public-sector capital.

In the current European fiscal framework, adherence to a fiscal policy satisfying sustainability is achieved primarily by restrictions on the deficits of member states. Except in extraordinary circumstances, deficits are to remain below 3% and cyclically adjusted balances should be in a position close to zero or in surplus. Cyclically adjusted budgetary figures are thought to reflect the medium-term position of public finances, since they adjust figures for the automatic reaction of budgetary flows to the business cycle. This rule is sufficiently simple that it avoids some of the forecasting problems described above, but the computation of cyclically adjusted budgetary indicators presents a number of additional complications.

First, there is no single agreed method for calculating cyclically adjusted budget balances and, hence, verifying that a nation has violated this criterion is problematic. Second, it is difficult to tell how much of an economic shock is transitory and how much is permanent. This is important because the deficit rule is meant to allow governments to temporarily smooth the effects of a short-run fluctuation around a long-term trend. A change in the trend requires a permanent change in fiscal policy. Third, under the criterion governments are supposed to run surpluses in good times so that they can run deficits in bad times. This leads to a time-inconsistency problem. If governments did not take advantage of good times in the past to run a surplus, then it is no longer optimal for the EU to insist that they must run a zero deficit over the business cycle, when a recession occurs. Anticipating this may be a reason why EU countries did not pursue more prudent policies in 1999 and 2000, when economic growth was strong.

3 This is similar to the stabilization game of Perraudin and Sibert (2000). Another related story is Alesina and Drazen's (1991) war-of-attrition game.

If problems associated with accounting issues and economic fluctuations are not too large, the SGP is likely to be effective in that a country that strictly adheres to its conditions is apt to remain solvent. To clarify this, suppose that there are no cyclical fluctuations. Then adhering to a zero deficit criterion requires that taxes cover current spending plus interest payments. The government budget constraint (equation (2.1)) then implies that the debt stock remains constant, $B_t = B_{t-1}$. This implies that, as long as nominal GDP growth is strictly positive, the debt ratio falls over time. The condition expressed in equation (2.3) holds and sustainability is ensured.

2.3 Optimal fiscal policies

We now discuss which fiscal policy maximizes national welfare and whether adhering to the SGP permits the pursuit of this policy. It should be noted that while the sustainability of a particular budgetary policy is a technical issue, the welfare consequences of a budgetary policy is a political issue. Which policies are optimal depends upon society's preferences.

A country's fiscal policy is a choice of a stream of both taxes and government spending, but current EU attempts to regulate fiscal policy are limited to restrictions on debt and deficits and do not include constraints on public spending. Thus, we will primarily focus on the optimal choice of financing a given stream of government expenditures.

Standard economic paradigms with long-lived households and costless lump-sum taxes show that equilibrium interest rates and consumption paths are invariant to whether current expenditures are financed with current taxes or by borrowing that is repaid with future taxes. To clarify this, imagine that the government cuts taxes in time t , borrows and increases taxes in time $t+1$. Equation (2.4) ensures that the present discounted value of its taxes is unchanged. Hence, from the households' point of view this has no effect on wealth. The distribution of taxes and deficits over time is irrelevant. In a frictionless, undistorted economy with long-lived households, long-run solvency is all that matters.⁴ In practice, however, various frictions and distortions exist and they imply that not only does government spending matter, but the way it is financed matters as well. The three following scenarios illustrate this. They also show how and why the current European fiscal framework may hinder the pursuit of optimal policies.

In the first scenario we suppose that there are no business cycles; nominal income growth and the nominal interest rate are strictly positive constants; and the government wants to finance a stream of public expenditures that are a constant share of GDP. We also assume that taxes are distortionary or require real resources to administer or comply with and that these associated costs increase at an increasing rate with the level of taxes.⁵ In this case the timing of taxes and deficits does have a real effect. If society has a preference for smooth consumption paths, then the government can minimize the costs associated with taxes by smoothing them over time. This could be accomplished with a constant pri-

4 Of course with short-lived households the burden of the taxes across generations is affected by their timing and this Ricardian equivalence no longer holds.

5 In this case the tax revenue in equation (2.1) is net of the administrative cost.

mary deficit-to-GDP ratio, d^* . However, the sustainability condition (equation 2.4) implies that this would violate the government's intertemporal budget constraint, unless the current debt ratio is zero or the nominal GDP growth rate exceeds the nominal interest rates. Running a constant deficit ratio is not generally consistent with sustainability. This implies that the deficit criterion of the Maastricht Treaty is not under all circumstances sufficient to assure sustainability. If the nominal interest rate exceeds nominal GDP growth and the government has a positive stock of debt initially, sustainability requires that the government runs a sequence of decreasing surpluses over time as nominal income growth causes its debt-to-GDP ratio, and hence its interest payments, to decrease over time. In contrast, if the nominal growth rate exceeds the nominal interest rate, the government could run a deficit permanently and yet grow out of its debt in the long run. Forcing it to obey the deficit criterion of the SGP would be undesirable and cause a welfare loss.

In the second scenario, suppose that a country is subject to cyclical shocks and that households are credit-constrained and unable to smooth their consumption to the degree that they would if they could borrow as much as they wanted. Then the government faces a trade-off between further smoothing consumption, which it can do by increasing taxes in good periods and decreasing them in bad periods, and minimizing the costs of taxes by smoothing them. It should dampen, although not entirely smooth away, the effect of the shocks. A 3% upper bound on its admissible deficit may be too restrictive to permit this. In the current economic downturn, for example, strict adherence to the 3% deficit limit may be hard to justify.⁶

In the third scenario, consider a country where government spending on infrastructure would benefit both current and future generations. It is optimal for the government to increase its spending, but there is no reason that the current generation should bear the entire cost. With increasing costs of taxation, it is not optimal for the current spending to be financed by current taxes. On both equity and efficiency grounds, it may be desirable for the government to run deficits. In this scenario, the restrictions on the size of deficits may interfere with both the government's ability to smooth taxes over time and its ability to spread the tax burden over the different generations that benefit from its current spending. While this scenario is particularly relevant for the EU accession economies, a similar argument can be made for the financing of labour market reforms in countries such as Germany and France.

Frameworks for attaining desirable fiscal policy are difficult to design. Because government spending can be aimed at redistributing wealth, as well as financing public goods and stabilizing the economy, the socially optimal level of spending is partly a matter of preference. Given spending, the optimal financing mix depends on the state of the economy. *Ex ante*, it is impossible to describe every conceivable state and to specify the optimal response. *Ex post*, it is costly or impossible to observe and verify the state and whether or not the specified policy has been implemented.

The difficulties associated with observing and verifying whether or not a country has satisfied even a simple numerical restriction on its deficits imply that if a fiscal framework is to be credible, it must be extremely simple.

6 If a bad economic shock also lowered tax revenues, the government could reduce its deficit by cutting spending. However, this is not consistent with its goal of smoothing consumption.

However, if it is simple, then there can be situations, such as the current economic slowdown, where abiding by the restrictions may not be optimal. Nations will then have an incentive to disregard or to renegotiate the framework as they are now doing. This has the ill effect of damaging the credibility of the EU to commit itself to a fiscal rule.⁷

In addition, the possibility of *ex-post* renegotiation may lead policy-makers to attempt to bolster their bargaining power in this renegotiation by worsening the outcome for the other countries if agreement is not reached. Ways they might do this include increasing their government spending above what it otherwise would have been and reducing their efforts at reforming costly or distortionary tax systems.⁸

2.4 Fiscal coordination and monetary policy

A couple of other arguments for restrictions on national fiscal policies have received serious attention and we will discuss them briefly. The first argument is that unconstrained national fiscal policies can put pressure on a monetary union's central bank to inflate, and it goes as follows.

Suppose that there is an outstanding stock of nominal government debt. If the interest rates on this debt are not indexed, then market participants take into account their expectation of inflation when the interest rates are determined. Once the interest rates are set, the central bank can collect an inflation tax by inflating more than market participants expected. The resulting inflation is costly, but if direct taxes are distortionary or costly to administer or comply with, then the cost of the inflation may be worth the benefit of lower real debt payments and, hence, lower direct taxes.

The public understands the central bank's incentive to inflate and incorporates it into its expectation of inflation. Nominal interest rates must be such that, when weighing the costs and benefits of inflation, on average the central bank chooses the inflation rate that the public expected. The result is that the central bank inflates, but it does not collect an inflation tax.

The situation is made worse when national governments choose their fiscal policies independently. When an individual government decides how much debt to issue, it knows the motives of the central bank and the resulting expectations of the public; it knows that an increase in its debt will lead to union-wide inflation. It takes into account the cost to its own residents of this inflation, but not the cost to the residents of the rest of the monetary union. The result of this free-rider problem is a sub-optimally large amount of debt and even higher inflation than if fiscal policies were coordinated.⁹

The above argument appears to have some validity. The Maastricht Treaty mandates price stability as the primary objective of the ECB, but this is not unambiguous and it is possible that the ECB's announced intent to pursue low inflation is not perfectly credible. The central bank may have an incentive to

7 This trade-off between simplicity and flexibility will be discussed in more detail in Chapter 4.

8 This is similar to the hold-up problem described in Hart and Moore (1988).

9 Chari and Kehoe (1997) provide a version of this argument where the central bank wants to collect an inflation tax, not to lower distortionary direct tax, but because some of the debt is held by foreigners and it does not care about their welfare.

lower interest rates and reduce the outstanding stock of real debt, especially if policy is influenced by governments acting in their national interests. The Maastricht Treaty forbids national governments from pressuring the central bank to lower interest rates. It may, however, be difficult to observe and even more difficult to verify when pressure is being applied.

There is a long literature on central banks' proclivity to produce an inflation bias. A desire to lower real interest rates in an attempt to improve the fiscal situation is one reason for the bias. Another is that, in the presence of (non-indexed) nominal wage contracting, inflation lowers real wages, increasing employment and output. As in the debt story, market participants expect the inflation and incorporate it into contractual nominal wages. The result is too high inflation without employment gains. Constraints on fiscal policy would reduce a central bank's incentive to lower real interest rates, but would not reduce its incentive to lower real wages. Indeed, if restrictions on fiscal policy exacerbate unemployment, they may increase the central bank's incentives to lower the real wage.¹⁰

The above story does not seem to provide a convincing justification for fiscal constraints. As noted, non-cooperative fiscal policy only exacerbates one source of the central bank's inflation bias and an inflation bias only exists if the institutional design of the central bank is such that its commitment to low inflation is not seen as credible. Appropriate central bank legislation, restricting the ability of the central bank to inflate excessively and making it sufficiently independent, transparent and accountable enough to resist national pressure is more attractive.

2.5 Interest rate and government spending spill-overs

The second additional argument for EU-wide regulation of national fiscal policy is that one country's or group of countries' fiscal policy has spill-overs for other countries. Increased government spending by one country or group of countries may crowd out other forms of spending in the world economy and it may also stimulate world demand and increase world output. The signs and magnitudes of the effects on different countries depend upon the institutional features of the economies, their sizes and links with other economies, on whether the spending is on government consumption or government investment.

Increased deficits, without a change in government spending, can also have consequences for the rest of the world if they change the world interest rate and, thus, change the cost to other countries of servicing their debt. This sort of *pecuniary* externality follows any price change and cannot be considered a source of inefficiency in an undistorted competitive market; indeed, the interest-rate change is the mechanism that ensures the proper allocation of debt. If costs associated with taxes are increasing, however, as previously discussed, the interest-rate change may cause positive or negative spill-overs depending on initial deficits and the timing of tax changes.

If uncoordinated fiscal policy is sub-optimal because of a negative externality, then there are three standard solutions. (Solutions for positive externalities

10 This point is made in Canzoneri and Diba (2000).

are analogous.) First, the EU could impose a quota on the activity generating the externality. If the EU could identify the optimal level of government debt for each country, it could mandate that countries do not exceed these levels. This would be a rationale for the Pact's debt ceiling. Second, the EU could impose a Pigovian tax on the increased debt or give a subsidy for debt reduction.¹¹ Unfortunately, to replicate the EU-wide social optimum, both this and the first solution require the EU to have a great deal of information about the benefits to a country of issuing a sub-optimal amount of government debt. The third solution is suggested by the Coase theorem. If an externality exists, then the government can issue tradable property rights over the activity generating the spill-overs. For example, the United States has found that issuing tradable permits for SO₂ emissions has been a low-cost way to reduce air pollution.¹² The analogue here would be for the EU to issue debt permits. The idea is that bargaining over these permits would lead to an efficient solution without additional government interference and without the government having to know the preferences of individual policy-makers.¹³

We attach little weight to the above argument, however, for restricting or otherwise regulating or influencing the debt of individual countries. The primary reason for this is that in a world with internationally mobile capital, the European and world interest rates on similar assets must be the same. Thus, for the fiscal policy of any one European country to affect the European interest rate, it must affect the world interest rate and no single European economy is large enough to have a significant effect on the world interest rate. Likewise in an integrated world economy, it is likely that no single European economy's spending is so large that it is likely to have a significant effect on the output of any other European economy. Thus, it is not obvious that interest rate and government spending spill-overs alone constitute a pressing case for fiscal coordination.

Concerted actions by member states or a large enough subset of member states, however, may have a non-negligible effect on the world interest rate and produce significant spill-overs both for Europe and for the rest of the world. But it is not obvious that this constitutes a case for intra-European coordination. A well-known result from game theory teaches that cooperation among a subset of the players of a game is not necessarily desirable, it may instead worsen the outcome of the game as a whole. This implies that intra-European fiscal cooperation may deteriorate the outcome of the fiscal policy interaction between Europe and the rest of the world.¹⁴

11 Beetsma and Uhlig (1999) propose a fine for each additional unit of debt issued.

12 See Schmalensee et. al. (1998) for a discussion of this.

13 This idea is suggested by Casella (2001). See Mas-Colell et al. (1995) for a general discussion of solutions to externality problems.

14 This is the result of Eichengreen and Ghironi (1997) in their simulation of a three-country Mundell Fleming model.

2.6 Why are governments tempted to follow socially undesirable fiscal policies?

EU-wide oversight of an individual country's fiscal policy and a system of incentives and constraints to ensure that it follows an appropriate policy might increase welfare in that country if its government has an incentive to follow a policy that does not maximize its residents' welfare. In this section we explain why a government might follow a sustainable, but undesirable, fiscal policy. We assume here that a country's policies have no spill-overs for other countries.¹⁵

A variety of arguments can be used to explain why governments might be tempted to follow fiscal policies that are sustainable but not optimal. We relate four of them.

First, government spending may be systematically too high. This may be because well-organized special interest groups which want increased spending in particular areas are more efficient rent-seekers than larger, but more disorganized political groups who are opposed to such spending.¹⁶ Second, it is suggested that the complexity of tax structures disguises some taxes, causing the median voter to underestimate the cost of public services.¹⁷ Third, it may be that the median voter has less than mean income and this encourages the provision of redistributive public services.¹⁸ Fourth, free-rider problems in legislatures can cause excess spending on pork-barrel projects that benefit a small group and have costs that are borne by the economy as a whole.¹⁹

Excessive government spending need not be associated with unwise budgetary policies. If we suppose, however, that households are finite-lived and that unborn households are under-represented in the political process, then there may be a tendency to finance the overly high government spending by borrowing today and levying taxes on future generations to repay it. The current problems in Europe resulting from under-funded social security systems are partially a result of unpleasant demographic and productivity surprises, but they may also be an example of burden-shifting across generations.

A second argument is that governments may run up debt to constrain their successors. Imagine that a country has two political parties and that these parties have different preferences over the composition of public spending. Suppose administrative and compliance costs imply that there are increasing costs associated with taxes. If the party in power knew that it would always remain in power, it would run a balanced budget so as to smooth taxes and minimize their associated costs. If the party that is currently in power is uncertain that it will be re-elected, then it may attempt to constrain the spending of the opposition, should they win the next election, by financing its spending by borrowing.²⁰

15 The following are primarily arguments for why a country might follow a sub-optimal fiscal policy rather than an unsustainable fiscal policy. However, in the presence of economic shocks, a large enough increase in government spending or the current stock of debt might increase the risk of insolvency.

16 There is a long literature on this. See e.g. Downs (1957).

17 See Oates (1988).

18 See Meltzer and Richard (1981).

19 See Chari and Cole (1993) and Hallerberg and von Hagen (1999) for an application to the European context.

20 This story is due to Tabellini and Alesina (1990).

A third argument arises in the political business cycle literature. Elections give governments an incentive to sub-optimally distribute taxes over time. Suppose that governments differ in their ability to provide public goods. Competent governments can do so at low cost; incompetent governments must spend more. If a government's competency is its private information, then prior to elections competent governments may attempt to distinguish themselves from less competent ones by lowering taxes below their optimal level. This signals that they can provide the public good without spending as much as a less competent government would. If the cost of the tax distortions exceeds the benefit of the information provided by the government's signal, then the political business cycle is harmful.²¹

One might question why it should be the concern of the EU to regulate or influence national behaviour so long as this behaviour does not have significant consequences for other countries. It is clear that preventing a national economic collapse that could threaten the area-wide financial system or destabilize the common currency is a proper role for the EU. But why should there be a centralized attempt to influence otherwise national economic policies?

It might be argued that the welfare of an individual nation is the proper concern of the EU; however, there is another reason as well. Sub-optimal fiscal policies are often the result of a nation being unable to constrain itself *ex ante* from following opportunistic behaviour.²² For example, consider again the story where competing political parties run up too much debt when they are in office because they want to constrain the spending of the other party when it takes office. *Ex ante* both parties might prefer that they could both agree not to borrow excessively when in office. Once a party is in office, however, it has an incentive to behave opportunistically. Both parties may benefit if it is possible to commit to obeying a 'third party' external enforcer. Thus, they may be able to improve their welfare if they can legally bind the nation to participation in a European fiscal framework, even though both parties know that if they should take office afterward, they will regret their commitment. It is unclear, however, whether a framework based on uniform policy rules for all EU member states is an appropriate answer to such a problem. The external enforcer would have to judge what a truly optimal fiscal policy for the country would be, and this judgement would have to be based on the specific circumstances and preferences of the country. A rules-based approach is unlikely to deliver that.

2.7 Conclusion

Even rational governments may follow fiscal policies that produce a significant risk of default. The cost of such default for the area as a whole provides a justification for a European fiscal framework aimed at ensuring long-run solvency.

Sustainability of public finances requires that the present discounted value of the stream of primary government budget deficits plus the value of the current

21 This is the story in Rogoff and Sibert (1988).

22 An example is the United States's attempt to restrain its own fiscal policy by enacting the Gramm-Rudman legislation of 1985. As soon as the deficit targets specified in the act became binding, the US congress passed new legislation modifying them. See Alesina (2000).

debt must equal zero. Accounting and forecasting problems make it difficult to ascertain whether or not a country's current fiscal policy is sustainable or not. Compliance with the restrictions embodied in the SGP is likely to ensure solvency, but the existence of business cycles presents some complications.

Abstracting from business-cycle considerations, optimal fiscal policy may require smoothing deficits over time and this is inconsistent with the falling surpluses that are required for stability and adherence to the deficit criterion of the SGP. With business-cycle fluctuations, governments may want to run deficits and surpluses to smooth consumption over the cycle. If economic shocks are large, this may be inconsistent with the Pact's 3% deficit rule. A government may want to finance productive government spending by borrowing to distribute the cost of the spending across the generations that benefit from it. This may also produce deficits that are too large to be consistent with the rules of the Pact. Thus, adherence to the Pact may produce fiscal policy that is sustainable, but inefficient.

Designing an optimal framework is difficult; credible enforcement requires simplicity. If the framework is too simple, however, it may produce sub-optimal outcomes, as in the above scenarios, and incentives for a subsequent renegotiation of the framework.

Other arguments for fiscal coordination besides the cost to the area of a country's insolvency have been made. First, uncoordinated fiscal policy can produce sub-optimally high inflation and stocks of public debt in a monetary union. The best solution to this problem, however, is not fiscal coordination but a central bank design that promotes credible adherence to low inflation. Second, interest rate and government spending spill-overs can make uncoordinated fiscal policy inefficient from the point of view of the EU as a whole. The magnitude of the costs associated with this, however, is likely to be small. Third, governments may not be able to commit themselves to an optimal fiscal policy. Delegating authority to a third party enforcing better fiscal policies may raise their welfare. Even if this were the case, however, it is unlikely that uniform rules for all EU member states are an appropriate solution.

3 Experiences with the Stability and Growth Pact

3.1 Introduction

The link between public finances and economic growth has been centre stage in the recent debate on the operation of the SGP. On the one hand, economic growth is a major determinant of budgetary performance, and therefore affects the sustainability of public finances. On the other hand, fiscal policies affect economic growth. This relationship between growth and fiscal performance has shaped three key issues in the debate.

The first important issue is the effectiveness of the SGP. The question is whether the improvement and deterioration of the nominal debt and deficit ratios are mainly the product of economic fluctuations or the degree of fiscal discipline induced by the Pact. While some observers were quite complacent with respect to the disciplining impact of the SGP during the initial years, others pointed out that the improvement of budgetary balances was mainly the result of economic growth. Later on, the economic downturn was made the culprit for the excessive deficits emerging in several countries, instead of the lack of willingness to restrain public finances. The European Commission and the ECB have argued that the budgetary problems that large EU member states are facing at the moment are mainly the result of a lack of fiscal discipline during the initial economic upswing. In the smaller economies, however, the framework has produced the degree of fiscal discipline necessary to comply with the requirements of the Pact. Thus, there is no unanimous view on the effectiveness of the European fiscal framework over time and across commentators in the member states or institutions.

The second issue is the controversy between the need to comply with the restrictions of the European fiscal framework and the stabilizing role of public finances. Critics of the framework complain that it is most restrictive especially when fiscal policy is needed the most to compensate for the loss of monetary authority to stabilize the economy. In particular, the 3% reference value for the deficit set in nominal terms could become counterproductive during economic downturns. To avoid an excessive deficit, governments may be forced to engage in pro-cyclical policies by cutting expenditures and increasing taxation when they approach the deficit limit. This undermines demand and the stabilizing role of public finances. Conversely, supporters of the European fiscal framework argue that the Pact is written to ensure the stabilizing role of public finances. Obeying the close-to-balance-or-in-surplus requirement would enable governments to let automatic stabilizers operate freely and without risk of running an excessive deficit above 3% of GDP.

The third issue is the relationship between fiscal sustainability and long-term growth. The need to comply with the requirements of the fiscal framework, so the argument goes, may induce governments to raise distortionary taxes or reduce productive government expenditures, thereby creating negative supply-side effects and hampering long-term growth. This reduces economic welfare and it is counterproductive for the sustainability of public finances. In particular, the current situation of Germany has led policy-makers and commentators alike to emphasize the need to improve economic performance as a condition for improving budgetary prospects in the long run. In this view, economic growth should receive precedence over a strict application of the fiscal rules. In contrast, more institutionally oriented commentators worried about the credibility of the framework argue that preserving fiscal discipline in the first place carries positive growth effects through lower interest rates and confidence-building.

In this chapter we will deal with these issues in turn. The next section describes fiscal developments under the SGP and traces the importance of economic growth and interest rates for fiscal consolidation and deterioration. Using a growth accounting framework, we ask how much fiscal consolidation the SGP achieved. We show that most of the consolidation in the past four years was achieved through growth, while the primary deficits expanded either to spend any new revenues or to keep expenditures constant relative to trend. That, of course, means deficits expand once growth slows.

Given the strong empirical evidence of the role of economic growth for fiscal performance, we then discuss whether the European fiscal framework has been conducive to growth-enhancing fiscal policies. We first analyse if the structure of fiscal consolidations conducted over the last decade has undermined economic growth. Then we evaluate whether the strictures under the SGP have precluded the operation of counter-cyclical fiscal policy. Empirical evidence which is presented in the following two subsections suggests that tax-driven consolidations have actually been less advantageous to economic performance than expenditure-led consolidations, above all due to their significantly worse impact on investment growth. Moreover, we show that fiscal policy has neither become more pro-cyclical, nor more clearly counter-cyclical under the SGP.

Finally, we look at the relationship between public finances and long-term economic growth. The European experience shows that sufficient long-term growth is a precondition for a significant reduction of the debt burden. Furthermore, long-term growth can be improved by the good quality of public finances.

3.2 Fiscal policy in practice: deficit reductions

3.2.1 The budgetary targets

Prior to 2002, few countries had problems with reaching the budgetary targets set for them under the SGP. Table 3.1 shows the official targets for 2001, in both actual and cyclically adjusted terms, as defined by the national stability and convergence programmes agreed with the European Commission together with the corresponding outcomes. It can be seen that, even in 2001, Germany and

Portugal were the only countries with deficits that failed to meet their targets, France being a marginal case. Only Germany and Portugal did not achieve the Commission's 'minimum benchmarks' for cyclically adjusted balances, France being a marginal case, again.¹ The European Commission (2002b) clearly expected that these benchmarks would remain valid until 2004 or later. Significantly Buti et al. (2003), European Commission (2000) and IMF (1998) all came up with very similar benchmarks for the maximum allowable deficit targets consistent with avoiding the 3% deficit limit. The country-specific deficit targets suggested by Artis and Buti (2000) are not much different either. The early warning procedure, however, clearly failed to provide any effective early warnings, spectacularly so in the case of Portugal.

Table 3.1 Fiscal targets and outcomes for 2001 (% of GDP)

	Actual fiscal balances		Cyclically adjusted budgets		
	Target	Outcome	Target	Min. benchmark	Outcome
Austria	-0.8	0.1	-0.5	-1.0	-0.3
Belgium	0.2	0.2	-0.5	-1.0	-0.7
Finland	4.7	4.7	+1.0	-1.0	+3.4
France	-1.0	-1.5	-0.5	-1.5	-2.0
Germany	-1.5	-2.7	-0.5	-1.5	-2.3
Greece	0.5	0.1	-0.5	-1.0	-0.9
Ireland	4.3	1.4	-0.5	-1.0	+0.5
Italy	-0.8	-0.8	-0.5	-1.5	-1.2
Netherlands	0.7	1.1	+1.0	-1.0	+0.8
Portugal	-1.1	-2.2*	-0.5	-1.0	-2.5
Spain	0.0	-0.9	-0.5	-1.0	-0.4
Denmark	2.8	2.2	+1.0	-1.0	+1.0
Sweden	3.5	4.7	+1.0	-1.0	+3.0
UK	0.6	0.5	-0.5	-1.5	+1.0

Notes: '-' denotes a deficit.

*This figure was revised to -4.1% in July 2002, i.e. well after the deficit period was finished. That indicates the Pact's early warning procedures may be rather ineffective – especially when there are difficulties in obtaining accurate and timely information from the national statistical services.

Source: European Commission (2001), taken from the individual Stability and Convergence Programmes; OECD Economic Surveys 2002.

Yet on the commonly applied standard of having a cyclically adjusted budget approximately in balance, a number of countries nearly failed. The only euro-area countries passing that standard in 2001 were Austria, Ireland, the Netherlands, Finland and Spain; and the non-EMU countries, Denmark, Sweden and the UK. By the end of 2002, all countries except Ireland and Finland failed that test. The fact that this had happened when the targets for actual deficits appeared to be broadly satisfied, suggests that the targets for cyclically-adjusted

1 A stricter application of the cyclically adjusted target values might conceivably bring Italy, and possibly Greece, into the story here – although both actually satisfy their minimum benchmark requirements comfortably. As those requirements were reaffirmed by the Commission to be the appropriate standard of judgement (see European Commission 2002b), we have ignored both countries in this discussion. But Table 3.1 does suggest that they may well be the next countries to show excessive deficits under the SGP.

budgets should have been tighter. Moreover, Germany, France, Portugal and, arguably, Italy had problems in terms of their actual budget deficits in 2002 as well. It is difficult, however, to tell from that observation whether the deficit targets were too low or whether countries did not curb their expenditures effectively.

3.2.2 How much budget discipline has the SGP achieved?

Two developments mark the years from 1999 to 2001. First, a recovery of the EU economies from the impact of their 1997–8 financial difficulties. Second, a continued improvement in the member states' budget balances, illustrated by the decline in the average debt-GDP ratio for the EU as a whole from 71.1% to 63.1%. For the euro zone, its decline was somewhat smaller, from 75.5% to 69.5%. These improvements, however, could be the result of stronger economic growth rather than continued efforts to achieve budget balance. Since 2001, the EU has been troubled by rapidly increasing fiscal deficits. France and Germany went past the reference value of 3% of GDP in 2002 and 2003. Again this could have happened either because governments operated budgetary controls that were too weak, or because growth slumped. To understand how the SGP has worked, we need to know the correct explanation.

We use growth accounting to see how much of a given change in the deficit ratio of a country was due to a change in the numerator (changes in spending and revenues), and how much was due to changes in the denominator (economic growth). In order to do this, we have to estimate the change in the deficit ratio assuming a 'neutral' fiscal policy, and compare it with the actual change in the deficit ratio. The former indicates the contribution of economic growth to the change in the deficit ratio, while subtracting it from the actual change yields the contribution of active fiscal policy, or the fiscal policy stance. A negative contribution of the fiscal stance to the deficit ratio means that the government actively tightened fiscal policy. If the SGP has increased fiscal discipline in EMU, we expect that the contribution of the fiscal stance to the deficit ratio was negative, or at least not positive.

Defining what a 'neutral' fiscal policy is in practice is obviously a crucial step in this exercise. Since there is no generally accepted definition for this purpose, we report the results of using three separate and plausible definitions. While they make little difference to the general thrust of our results, they have very different interpretations, and they reveal quite a lot about the different strategies which national governments have been following.

A programme of effective expenditure restraints

Our first definition of fiscal consolidation is the most stringent. We follow Hughes Hallett (2001) and write the deficit ratio, d , as

$$d = \frac{G - T}{Y} = g - t, \quad (3.1)$$

where T denotes total government (tax) revenues, G total government expenditures and Y national output (GDP). Thus $g = G/Y$ is the share of overall government spending in GDP, and $t = T/Y$ is the average tax rate. Our first definition says that a neutral fiscal policy keeps the average tax rate and the volume of

government spending constant. Thus, $\Delta T = t \Delta Y$ and $\Delta G = 0$. This is exactly how the French government's promised fiscal programme is defined at the moment, for example. The contribution of economic growth to the deficit ratio is then given by

$$\Delta d = -\frac{t\Delta Y}{Y} - \frac{\Delta Y}{Y}(g-t) = -\gamma\bar{g} \quad (3.2)$$

where γ denotes the rate of growth of national income. The sensitivity of the deficit ratio to changes in the rate of growth,

$$\frac{\partial d}{\partial \gamma} = -(t+d) = -g. \quad (3.3)$$

shows that the largest effects of any changes (positive or negative) to the growth rate will appear in the high public-spending economies.

Expenditure growth in line with revenue growth

Alternatively, we define a neutral fiscal policy to be one in which the average tax rate is constant and public expenditures are allowed to grow in line with revenues, but not beyond. With this definition, the growth effect on the deficit ratio becomes

$$\Delta d = -\gamma d \quad (3.4)$$

This definition is interesting because it shows what would happen if governments spend any new revenues as they come in.

Expenditure growth in line with trend GDP

A third possibility is to define a neutral fiscal policy as one in which the average tax rate remains constant, and the level of government spending is kept at a constant proportion of trend GDP. This yields a growth effect on the deficit of

$$\Delta d = (g\bar{\gamma}Y - t\Delta Y - \gamma(g-t)) = g(\bar{\gamma} - \gamma) \quad (3.5)$$

The deficit falls with a neutral policy, if output grows faster than the trend growth rate $\bar{\gamma}$; but the deficit rises otherwise. This definition is of interest, because the size of the public sector should be determined by society's preferences in the long run.²

2 Maintaining public expenditures as a constant proportion of trend output with constant average tax rates is also the 'neutral fiscal policy' reference path used by Buti and van den Noord (2003). Their definition of discretionary changes in the deficit therefore measures only changes in spending (or revenues) above or below that trend, and hence only the extent to which growth and inflation 'surprises' have allowed the fiscal position to expand or contract. They do not measure the extent to which growth itself would have permitted fiscal policies to expand (no consolidation); nor how much growth would have given policy-makers the space to consolidate their deficits without imposing contractions in absolute expenditures or revenues (a measure that would have shown whether they had taken advantage of that opportunity or not). Nevertheless, even with that limited definition, Buti and van den Noord still find that the euro-area countries underwent fiscal expansions during 1999–2002; and that these expansions were in part motivated by the electoral cycle. Their results are consistent with our results shown in Tables 3.2–3.5 and with Galí and Perotti's (2003) evidence of stronger counter-cyclicality in EU fiscal policies than elsewhere.

Interest payments

Total fiscal expenditures include interest payments on public debt, so that falling debt levels and reduced interest payments affect total government spending. Let r be the average interest rate paid on government debt, B the volume of government debt and b the debt-GDP ratio.

The change in the ratio of interest payments to GDP is

$$\Delta(rb) = (\Delta r)b + r(\Delta b) \quad (3.6)$$

The first term on the right-hand side of (3.6) represents the fiscal gain from lower interest rates, which is a measure of the contribution of monetary policy to the reduction in the deficit ratio. Note that interest rates fell sharply for some EMU member states as they approached monetary union during 1998. For these countries in particular, this first term represents the fiscal gain of improved monetary policy credibility in EMU. The second term is the budgetary effect of a falling debt ratio, a direct consequence of past fiscal consolidations.

Measuring the first term empirically is difficult, because we do not know the exact maturity structure and interest rates paid on a country's public debt. The relevant interest rates differ from current short-term market rates, because old debt is not refinanced all the time, because current debt contains short maturities with coupon values reflecting the interest rate at the point of issue rather than current market rates, and because public debt includes zero coupon or index-linked bonds. We approximate this term by the implicit average rates of interest rate on public debt, that is, the ratio of total interest payments and the volume of public debt.

To calculate changes in the net fiscal policy stance, we use the AMECO database.³ We first subtract the contributions of growth according to one of the definitions of a neutral fiscal policy, and of changes in the interest rate from the observed annual changes in the deficit ratio.⁴ Table 3.2 reports the observed changes in the deficit ratios in 1999–2002. The first four columns in Table 3.3 present the effects of the fiscal policy stance on the deficit ratio in the same years, using a policy of no expenditure growth as the definition of a 'neutral fiscal policy'. A positive value indicates a discretionary fiscal expansion; negative values indicate fiscal tightening. The second four columns of Table 3.3 present the effects of the fiscal stance on the deficit ratio, assuming that a neutral policy is one which keeps expenditure growth in line with revenue growth. The third four columns show the effects of the fiscal policy stance, assuming that a neutral policy keeps expenditures constant relative to trend output growth.

3.2.3 Fiscal policy stance after qualifying for EMU: 1999

Table 3.2 shows that all EU countries except Ireland enjoyed falling deficit ratios in the first year of EMU. However, Table 3.3 shows that Denmark was the only country in the EU that actually tightened fiscal policy during 1999 (column 1). None of the EMU member states did so, despite the SGP and the medium-term

3 The AMECO data base is produced and disseminated by the European Commission.

4 It is important to recognize that this procedure is simply an accounting exercise. It computes the actual contribution of fiscal policy, not the intended contribution (which may have failed because the fiscal variables are influenced by other factors such as monetary policy, external growth, trade, or the exchange rate); nor the indirect contribution which fiscal policy may have made by creating that growth or supply-side improvements.

goal of reaching balanced budgets. Thus, the observed improvements in the overall deficit ratios must be attributed entirely to the effects of economic growth during that year, plus the fiscal gains from an improved credibility in monetary policy. These effects more than compensated the underlying, discretionary expansions. Austria, Ireland, Portugal, Finland and Belgium, nevertheless, show the most expansionary fiscal stances. Since these countries also had a strong cyclical position during 1999, fiscal policy was clearly pro-cyclical for them. Fiscal policy in the core EMU countries, Germany, France and the Netherlands, also showed no signs of improved discipline in 1999. Outside EMU, the results are more mixed. Denmark tightened fiscal policy substantially, but the UK, Sweden and Greece eased.⁵

Table 3.2 Observed deficit ratio changes, 1999–2002

	Observed Changes (% of GDP)			
	1999	2000	2001	2002
Austria	-0.2	-0.8	-1.8	2.1
Belgium	-0.2	-0.6	-0.3	0.5
Finland	-0.5	-4.9	2.0	1.3
France	-0.9	-0.4	0.1	1.7
Germany	-0.7	-0.4	1.7	1.0
Greece	-0.7	0.1	-0.5	-0.1
Ireland	0.1	-2.3	3.0	2.4
Italy	-1.4	-1.1	2.0	-0.2
Netherlands	-1.5	-1.5	2.1	1.2
Portugal	-0.4	0.0	1.4	-1.0
Spain	-1.9	-0.3	-0.7	0.0
Denmark	-2.2	-0.7	-0.5	0.9
Sweden	-0.8	-2.2	-0.8	3.2
UK	-0.9	-2.8	3.1	2.0

Note: '-' denotes a fall (improvement) in the deficit ratio.

Source: Authors' calculations and the AMECO data base

Column 5 of Table 3.3 shows the fiscal stance based on the second definition of a neutral fiscal policy, that is expenditures growing in line with revenues, for 1999. With this more lenient definition of a neutral fiscal policy, only Ireland shows a significant fiscal expansion. Belgium and Portugal show some small tightening. To the extent that the figures in this column match those in the first column of Table 3.2, we can see which governments, instead of consolidating, just spent all of the extra revenues that were created during that year. Those governments were Belgium, Ireland and Austria. The others actually consolidated, to some degree, relative to allowing their expenditures to grow in line with revenues. Since the figures in column 5 of Table 3.3 are often closer to the rise in deficit ratios that would have happened had there been no growth and no extra expenditures (column 1, Table 3.3), we can see that all the remaining governments, except Denmark, did spend a significant part of their new revenues. France, Germany, Portugal, Finland, Greece and Sweden fall into this group. The extra amount they spent (as a proportion of GDP) is the difference between the figures in the fifth column of Table 3.3 and the first column of Table 3.2.

Table 3.3, finally, gives the outcomes for the deficit ratios, had spending been kept constant as a proportion of trend output. Comparing these figures with

5 Greece joined EMU on 1 January 2001.

Table 3.3 Fiscal stance, 1999–2002

	Fiscal policy stance						Fiscal policy stance					
	Neutral policy = no expenditure growth			Neutral policy = expenditure growth in line with revenue growth			Neutral policy = expenditure growth in line with GDP growth			Neutral policy = expenditure growth in line with GDP growth		
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Austria	1.81	0.24	-0.82	2.42	-0.06	-0.03	0.01	-0.01	-0.34	0.06	0.10	0.89
Belgium	1.68	0.31	0.91	0.98	-0.16	0.00	0.01	0.00	-0.55	0.01	0.05	0.86
Finland	1.66	-3.36	3.73	2.97	0.07	0.22	0.15	0.09	-0.27	-0.10	-0.11	0.21
France	1.16	0.81	1.27	2.36	-0.06	-0.03	-0.03	-0.03	-0.62	-0.05	-0.04	0.57
Germany	0.42	0.32	2.45	1.19	-0.03	-0.02	-0.04	0.00	-0.21	0.06	0.09	0.74
Greece	1.53	1.99	1.93	2.46	-0.07	-0.07	-0.05	-0.05	-0.27	-0.23	-0.22	-0.44
Ireland	4.38	0.05	5.80	3.64	0.26	0.33	0.11	-0.02	-1.30	-0.01	0.07	1.39
Italy	0.92	-0.37	2.87	0.62	-0.03	0.01	-0.04	-0.01	0.00	0.00	0.01	0.70
Netherlands	0.76	-0.31	3.33	1.49	0.03	-0.05	0.00	0.00	-0.65	0.07	0.17	1.23
Portugal	1.59	1.06	2.70	-0.34	-0.11	-0.07	-0.10	-0.03	-0.55	0.07	0.15	0.80
Spain	0.48	1.25	0.49	0.88	-0.05	-0.02	0.00	0.00	-0.51	-0.06	-0.03	0.39
Denmark	-0.42	1.94	0.85	2.28	0.09	0.06	0.07	0.04	0.21	-0.01	0.03	0.14
Sweden	2.42	-0.55	1.50	4.66	0.07	0.11	0.12	0.03	-1.21	-0.08	-0.05	0.26
UK	0.54	-1.99	4.27	3.07	0.03	0.08	0.02	-0.02	0.06	0.06	-0.04	0.06

Source: Authors' calculations and the AMECO data base.

column 1 of Table 3.2, we find that all governments consolidated relative to keeping expenditures on trend growth, except Belgium, Ireland, Austria and Sweden which expanded theirs faster than trend, the amount they did so (as a percentage of GDP) being again the difference between the figures in these two columns.

In sum, it seems that Belgium, France, Austria, Portugal and Greece show the biggest failures to consolidate their deficit reductions – along with Ireland, Finland and Sweden, who nevertheless had higher growth rates and larger surpluses to protect them. Only Denmark, the UK, the Netherlands and Spain made serious attempts to curb their expenditures at this point. Italy lies somewhere between that position and letting her expenditures grow with revenues. Belgium, Germany and Ireland also appear to have followed a strategy of spending only new revenues. France, Austria, Portugal, Finland, Greece and Sweden, on the other hand, were closer to expanding their public expenditures to keep them on their long-run trend. To conclude, there was rather little fiscal consolidation effort in most EMU countries during the first year.

3.2.4 Deficit changes in a boom period: 2000

The second year of EMU was one of exceptionally strong growth in the EU. Compared with 1999, we generally observe larger reductions in deficit ratios. Based on the no-expenditure-growth benchmark, Finland, Italy and the Netherlands made visible efforts to tighten their fiscal policies (and create rainy-day funds), as did Sweden and the UK outside the euro zone, while fiscal policy was neutral in Ireland. Belgium, Germany and Austria, in contrast, maintained moderately expansionary fiscal stances, while Spain, France, Portugal, Greece and Denmark had sizeable fiscal expansions.

Comparing the sixth column of Table 3.3 and the second column of Table 3.2, we see that all governments allowed public expenditure growth to absorb some of the growth in revenues during that year. In fact, Germany, Spain, France, Portugal and Greece appear to have allowed new expenditures to absorb a large portion of the extra revenues generated. However, no country actually went as far as allowing new expenditures to absorb *all* the new revenues. Similarly, no country went so far as to allow public expenditures to stay on trend relative to growth. The important point to take from Table 3.3, however, is that most governments – the governments of Finland, Italy, the Netherlands, Sweden and the UK excepted – did not use the opportunity even of a very strong economic boom to achieve some extra improvement in their budgetary positions.

3.2.5 A year with weak growth effects: 2001

The year 2001 was one of slow growth in the EU, due in part at least to the monetary tightening in the first half of the year. Table 3.2 (column 3) shows that the observed deficit ratios deteriorated in most EU countries. Among the EMU member states, Belgium, Spain, Austria and Greece still had some improvement in the observed deficit ratios; the same is true for Denmark and Sweden.

Turning to the fiscal stance in 2001, we see sizeable fiscal expansions in all EU states except Austria, if a neutral policy is defined as one that allows for no expenditure growth. These expansions are considerably larger than those of a year earlier. The interesting point here is that, contrary to conventional wis-

dom, the main loss of fiscal restraint took place in the immediate aftermath of the 1999–2000 boom, not in the recession of 2002. In 2001, fiscal policies that kept spending in line with revenues would still have produced very little change in the deficit ratios. Similarly, policies which kept spending constant relative to trend GDP, would have produced no more than some small fiscal expansions in Belgium, Germany, Ireland, the Netherlands, Austria and Portugal. Consequently, we can see that Germany, France, Ireland, Italy, the Netherlands, Finland and Portugal among the EMU countries (and the UK outside), all expanded their deficit ratios *beyond* what would have happened with a trend neutral stance or where only new revenues could be spent. These countries therefore failed to curb their expenditures as they came *off* the peak of their cycle. If this is the natural consequence of lags in the implementation of fiscal policy changes, then these results underline the need to have more forward-looking behaviour in the new fiscal regime. The clear lesson to be drawn from the experience of 1999–2001 is that the lack of explicit expenditure constraints (or tax increases) has led to a deterioration in European fiscal positions in the downturn. The scope of this deterioration would have been less if governments had saved more in the good years.

3.2.6 The recession effects in 2002

Finally, we turn to 2002, a recession year in the EU. Apart from Spain, Italy and Greece, all EU countries experienced rising observed deficit ratios during that year. This might have been due entirely to the operation of automatic stabilizers. The fourth column of Table 3.3 paints a different picture, however, indicating strong fiscal expansions in all countries except Portugal. Nevertheless, some countries managed to hold back any increases in their fiscal position, despite the recession. Germany, Ireland, Italy, the Netherlands, Portugal and Finland in fact reduced their fiscal expansions compared with 2001, while the remaining countries (Spain, France, Finland and Greece) switched to a more expansionary fiscal stance. Table 3.3 meanwhile shows that only Spain, Italy and Portugal managed to restrict their expansions to less than keeping expenditures in line with revenue growth. Similarly, only Belgium, Spain, Italy and Portugal restricted their net expenditures to increase by less than trend growth. The Netherlands allowed its net expenditures to grow at the same rate, while the other countries allowed their expenditures to grow faster than that.

We conclude from this exercise that a separation of the effects of economic growth and active fiscal policy on the deficit is indeed crucial to understanding the working of the SGP in the first years of EMU. Overall, the results show that the SGP has achieved little, if any, strengthening of fiscal discipline in EMU. In most years and most countries, the observed improvements in the deficit ratios during the years of strong economic growth were due to growth rather than active policy adjustments. Most governments chose to let spending grow with revenues or trend output over this period. Relative to a policy of tight expenditure restraint, fiscal policies were generally expansionary even when growth was strong. Relative to a policy of keeping expenditure growth in line with trend GDP growth, policies were tight in 1999–2000 but expansionary in 2001–2002. This suggests that the SGP in particular lacks strong incentives for expenditure control. In particular, mechanisms to induce restraint in good times would make the SGP more effective.

3.3 Debt reductions and the sustainability of public finances

One of the features of the SGP is its asymmetry; it applies a limit to the deficit ratio, but does not require surpluses or specific measures to ensure the sustainability in the long term. Nevertheless, growth evidently has had a greater effect in bringing down debt ratios in the euro area than it had on the deficit ratios. And it would have potential to continue to do so as long as the deficits are kept to a reasonable size (below 3% or 4% of GDP on average in most cases). This is hardly surprising since growth would be acting on the whole stock of debt in this case, rather than just the current deficit.

Table 3.4 provides the figures to make this point. The first four columns of that table show the debt reductions (sustainability gains) achieved over the period 1999–2002; and the second four columns show the potential deficit ratio gains achievable over the same period, had there been an effective programme of expenditure restrictions in place (these are the growth effects, under the expenditure freeze strategy, which underlie the deficit ratio outcomes in the first four columns of Table 3.3). It is clear that growth would have contributed a great deal to improving the sustainability of public finances so far. The first four columns of Table 3.4 show that debt ratios would have been reduced by three to four percentage points per year, on average, in most countries, even if their budget positions had not changed – although that has slowed into the recession of 2002. And an effective programme of expenditure controls could have added a further 1–2% to those reductions (the second four columns). Thus, all but Austria, Germany, France and Finland could have been reducing their debt ratios by an average of more than five percentage points a year (notice that we are averaging over a period of two good years and two bad years); and they would still have achieved reductions of 3% or more, compared with what actually happened, even without any budget consolidation.

Table 3.4 Potential contributions of growth to fiscal consolidation (% points)

	Actual debt reduction				Potential deficit reduction with expenditure controls				
	1999	2000	2001	2002	1999	2000	2001	2002	Total av.
Austria	2.34	0.70	1.59	1.56	1.68	1.09	0.96	0.01	2.48
Belgium	5.33	5.52	2.98	3.19	1.88	1.36	1.05	0.32	5.41
Finland	1.45	3.78	1.88	1.22	1.90	1.71	1.61	1.28	3.71
France	2.21	2.61	1.89	1.72	1.78	1.25	1.17	0.43	3.28
Germany	1.53	1.56	1.21	1.09	1.02	0.74	0.73	0.08	1.99
Greece	7.05	8.19	8.17	8.17	1.74	1.64	1.63	1.91	9.62
Ireland	7.74	5.73	4.14	3.98	4.11	2.85	2.54	1.48	8.15
Italy	3.74	5.85	5.02	3.34	0.89	1.05	0.84	0.08	5.20
N'lands	3.54	4.25	3.49	1.71	2.06	1.62	1.24	0.01	4.48
Portugal	3.76	3.70	3.61	2.93	1.78	1.18	0.94	0.29	4.54
Spain	4.45	4.72	3.95	3.50	1.81	1.63	1.37	0.90	5.58
Denmark	2.40	2.82	1.59	1.19	1.76	1.74	1.41	1.12	3.23
Sweden	3.32	3.00	1.73	1.69	3.14	2.08	1.59	1.37	4.48
UK	2.26	2.23	1.75	1.94	1.11	1.10	1.18	0.71	3.07

Source: Authors' calculations.

Those are significant improvements in sustainability. A 5% reduction rate would clear a 60% debt burden completely in 12 years; and a 3% rate would clear it in 20 years. That makes the case for switching to a sustainability criterion if, as it appears, the SGP has been unable to create much effective budget consolidation and has failed to impose effective expenditure controls in practice. In those circumstances, you lose little by relaxing the deficit rule itself because sustainability (being the larger component) will be safeguarded as long as there is growth and a sensible balanced-budget target in place.

One other observation: these remarks still hold good for the high-debt countries (Italy, Greece, Portugal and Belgium). Thus, growth does help the traditionally weaker-discipline countries to maintain discipline. The fact that it did not help the more disciplined countries as well, suggests the latter had had deeper seated structural problems in this period.

3.4 Growth, sustainability and the quality of public finances

The previous section has shown that economic growth has contributed importantly to the improvement of budget balances in EMU. In this section we look at the impact of public finances on growth. Higher growth reduces spending needs, generates revenues, contributes to the reduction of existing public debt relative to GDP, and allows for higher debt levels to be carried into the future without becoming unsustainable. If fiscal policy affects the growth performance of an economy, it has important consequences for the sustainability of public finances beyond the immediate budgetary consequences.

As a first step, we assess the role of the quality of public finances on short- and long-term macroeconomic growth and stabilization. The quality of public finances has two elements: a structural and a cyclical one. The structural element relates to the size and composition of public finances in terms of distortionary and non-distortionary taxes and productive versus consumptive spending. The cyclical element is captured by the pattern of fluctuation of the budget balance over the business cycle. As a second step, we assess how much the long-term growth effects contributed to the achievement of long-term fiscal sustainability.

3.4.1 Have fiscal consolidations undermined growth?

This subsection analyses the consolidation experiences of EU member states during the 1990s. It examines the extent to which the quality of the consolidation efforts affected macroeconomic performance. The quality of a consolidation is defined in terms of its size and composition. Fiscal consolidations can be based either on cutting expenditures or raising additional revenues. They can also change the mix of productive and non-productive public spending and the economic distortions caused by taxes. Empirical evidence⁶ indicates that fiscal adjustments based on the reduction of primary expenditures, and wages and transfers in particular, are more persistent and successful in terms of debt reduction. Expenditure-driven consolidations also seem to have a less contractionary economic impact in the short run.

6 See among others Alesina and Perotti (1997a) and von Hagen et al. (2002b).

Recent literature⁷ argues that the expectation and supply-side effects of fiscal consolidations counteract the conventional demand-side effects of budgetary contractions. Private consumption may go up in the face of a fiscal contraction if consumers anticipate a subsequent reduction in the tax burden. A reduction in public-sector wages and employment can generate a positive supply-side shock to employment in the private sector, causing unit labour cost to fall and private investment to rise. A similar channel exists for cuts in taxes on labour and more social benefit systems, which may follow expenditure-driven consolidations and lead to lower labour costs, gains in competitiveness and increased production.⁸

To capture the consolidation experiences of EU countries, one needs to identify the size and the timing of the fiscal adjustments appropriately. Following the European Commission, we use the primary cyclically adjusted budget balance as an indicator of fiscal adjustments. The identification of consolidation episodes is more problematic. To analyse the European experience, a fairly detailed and complete view of the recent developments is desirable and a low threshold for identifying consolidation efforts seems appropriate. Too low a threshold, however, carries the risk of identifying small, temporary effects and having 'noise' producing a blip in the data series recorded as a consolidation effort. Following Perotti et al. (1998), we define a consolidation as a reduction in the primary cyclically adjusted budgetary balance of more than 0.5% of GDP over the adjustment period. A consolidation is said to end only if the primary cyclically adjusted budgetary balance subsequently deteriorates by more than 0.5% of GDP.

It is useful to start with a short summary look at the consolidation episodes in our sample. Table 3.5 depicts the consolidation experiences of EU member states over the past decade. The first columns present the change in the primary balance, primary current expenditures and revenues, all in cyclically adjusted terms.⁹ The last column indicates whether the consolidation was primarily expenditure- or revenue-driven. We call a consolidation episode expenditure-driven if cyclically adjusted expenditures contributed more than 50% to the overall adjustment, and revenue-driven otherwise. We identify 33 consolidation spells ranging from one to six years, one-third of which were mainly expenditure-driven. The table also shows the overall improvement of the budget balance during the consolidation spell, the mean improvement of the nominal balance over this time period, as well as the debt development.

The table shows that three states pursued only expenditure-led consolidations. In a second group of countries, an expenditure-led strategy began in the mid-1990s, which was preceded and in some cases followed by a revenue-based consolidation. A third group of countries – Belgium, France, Germany, Greece,

7 Alesina and Perotti (1995, 1997a) as well as Perotti et al. (1998) argue that the structure of consolidations is important; Giavazzi and Pagano (1996) and Giavazzi et al. (2000) see mainly the size of the consolidation efforts as the chief factor for confidence-related non-Keynesian effects. Sutherland (1999) and Perotti (1999) provide theoretical models for why fiscal consolidations may not have a restrictive economic impact.

8 See Alesina et al. (2002), Alesina and Perotti (1997a), Lane and Perotti (1998).

9 It would be desirable to analyse the evolution of government transfers and wage consumption. As a result of the change in the accounting system from ESA79 to ESA95, however, there is a change in the recording of transfers, where now two subcategories are distinguished (social transfers and transfers in kind to individuals). We therefore decided to use the time series of current primary expenditures.

Table 3.5 Consolidation experiences in EU member states, 1992-2002

Country	Year	Consolidation	Δ Prim. Current Exp.	Δ Rev.	Δ Bal.	Mean Δ Bal.	Δ Debt	Strategy
AUT	1992	1.1	0.6	1.8	1.0	1.0	-0.3	rev
AUT	1995-7	3.4	-2.0	0.2	3.0	1.0	0.0	exp
AUT	2001	2.3	0.1	1.8	2.1	2.1	-0.3	rev
BEL	1993-8	4.6	-4.4	4.3	7.4	1.2	-12.9	rev
BEL	2001-2	0.9	0.4	1.1	-0.2	-0.1	-4.0	rev
FIN	1993-5	2.2	-2.3	-2.4	1.9	0.6	16.6	exp
FIN	1998-2000	0.8	-6.2	-2.2	8.5	2.8	-10.1	exp
FRA	1994-9	3.5	-1.8	2.1	4.4	0.7	13.2	rev
GER	1992-4	2.6	2.5	3.8	0.5	0.2	8.9	rev
GER	1996-9	2.2	0.1	1.4	2.0	0.5	4.2	rev
GRC	1992-4	7.7	4.2	5.1	1.5	0.5	25.6	rev
GRC	1996-8	4.0	-3.1	4.2	7.7	2.6	-2.9	rev
IRL	1992-4	1.6	-1.8	2.2	0.9	0.3	-12.4	rev
IRL	1996-8	1.0	-1.4	-0.1	2.0	2.0	-8.6	exp
IRL	2000	1.2	-1.3	-0.9	2.3	2.3	-10.0	exp
ITA	1992-3	4.1	2.6	5.0	1.4	0.7	17.5	rev
ITA	1995-7	4.0	-3.4	2.7	6.6	2.2	-3.6	rev
LUX	1992-6	7.0	-0.5	6.1	0.6	0.1	2.4	rev
NLD	1993	2.6	-0.6	2.3	1.4	1.4	1.2	rev
NLD	1996	1.9	-1.5	0.5	2.4	2.4	-2.0	exp
PRT	1992	3.1	-0.5	3.6	2.9	2.9	-6.3	rev
PRT	1994-5	1.8	0.8	3.9	1.4	0.7	5.2	rev
PRT	2002	1.2	0.7	1.5	0.8	0.8	2.0	rev
ESP	1992	1.6	2.2	2.3	0.3	0.3	-2.1	rev
ESP	1996-2002	2.7	-3.8	0.6	6.6	0.9	-8.9	exp
DNK	1992-3	2.0	2.5	5.1	-0.5	-0.3	15.5	rev
DNK	1996-9	2.9	-3.9	0.5	5.4	1.4	-16.6	exp
DNK	2001	1.1	0.0	1.1	0.3	0.3	-2.1	rev
SWE	1995-8	10.7	-6.3	1.9	12.7	3.2	-5.7	exp
SWE	2000-1	1.9	-2.3	0.7	3.3	1.7	-8.4	exp
GBR	1994-2000	7.3	-1.9	1.5	9.5	1.4	-3.3	exp

Source: Authors' own calculations

Italy and Luxembourg – implemented only revenue-dominated fiscal consolidation efforts.

Table 3.6 sheds some light on how these consolidations shaped the structure of public finances and affected economic growth in the short run. The table provides data for the level of public revenues as a share of GDP, current primary expenditures as a share of GDP, both in cyclically adjusted terms, and the effective average tax rate on labour. Economic performance is measured by the growth rates of real GDP, private investment and consumption as well as the trade balance. These indicators are taken as averages over the two years before, during and two years after a consolidation episode and calculated as differences from the respective GDP-weighted EU averages.

Table 3.6 Consolidation, quality of public finances and economic performance

	Revenue-led Consolidations			Expenditure-led Consolidations		
	Before	During	After	Before	During	After
Prim. curr. expenditure	38.70	39.30	39.30	43.1**	40.30	40.40
Revenues	44.90	46.90	47.00	50.02**	48.50	48.30
Labour tax	34.60	36.10	35.80	37.80	36.30	34.60
Δ GDP	0.17	0.09	0.56	0.98	1.57***	1.53
Δ Private investment	1.43	0.58	0.84	0.48	2.42*	1.74
Δ Private consumption	-0.70	0.30	0.31	0.00	1.09**	0.97
Trade balance	0.40	0.65	1.20	3.71**	3.71**	3.30
Memo item:						
Growth impact on public debt	-0.83	-17.8	-0.65	2.20	-3.08	-3.98**

Notes: Figures in the table are averages for all consolidation spells from 1992 to 2002. Asterisks indicate statistical significance at the 10 (*), 5 (**), and 1 (***) percent level for the test of equivalence with the respective mean for the revenue-based episodes. The number of observations varies due to missing observations caused by the censoring of consolidation spells. The average effective tax rates comprises social security contributions, pay-roll taxes and personal taxes from labour income (see Martinez-Monguay 2000). Data for the average effective tax rate on labour are only available until 2001.

The table reveals several interesting features of the structure of public finances. First, countries that started expenditure-driven consolidations had higher revenues than those countries that started revenue-driven consolidations. While cyclically adjusted public revenues were 50.2% of GDP before expenditure-led adjustments, they were 44.9% of GDP before revenue-led consolidations. During and after the consolidation episodes, the revenues decreased for expenditure-led consolidations. For revenue-based strategies, they increased to 47% of GDP so that the difference between groups of countries pursuing different consolidation strategies is not statistically different from zero any more.

Second, countries which undertook revenue-driven consolidations increased the average effective tax rate on labour by more than one percentage point on impact. By comparison, the tax rate fell by an average of three percentage points in expenditure-driven consolidations. Third, a notable difference in the development of current primary expenditures exists across consolidation strategies. In revenue-led consolidations primary expenditures remained fairly stable over the consolidation efforts. By comparison, average current primary expenditures fell from 43.1% of GDP before consolidations to 40.3% of GDP after the consolidations. After the adjustment spell they rose only moderately to 40.4% of

GDP. Transfers and government wage expenditures, which make up the bulk of current government spending, were clearly restrained under this strategy.

Looking at economic performance, we can compare our indicators for expenditure- and revenue-led consolidations. Table 3.5 points to two issues. The first regards the initial conditions of consolidations. Countries performed relatively well before starting a fiscal adjustment, suggesting that governments seem to be more willing to start consolidations when their economies are doing relatively well.¹⁰ This confirms the results reported by von Hagen et al. (2002a,b) for a larger sample of industrialized countries. The only clear difference in initial conditions between expenditure- and revenue-driven consolidations exists with respect to the trade balance, which was much larger before expenditure-led consolidations.

Second, real GDP growth relative to the EU average worsened somewhat during revenue-based consolidations. This is the result of stronger trade performance and private consumption, on the one hand, and weaker investment growth, on the other hand. During expenditure-driven consolidations, however, GDP growth increased by 0.6% relative to the EU average. The difference between expenditure and revenue-driven consolidations in this respect is statistically significant. Moreover, the growth rate remains persistently higher than the EU average rate after expenditure-driven consolidations. Stronger investment growth was a main contributor to the improved growth performance after expenditure-driven consolidations. It exceeded the EU average by 2.4%, compared with 0.58% for revenue-based consolidations.

Thus, expenditure-driven consolidations seem to induce higher private investment rates and improve international competitiveness, while revenue-based consolidations undermine private investment activity. This is consistent with the supply-side effects of expenditure cuts discussed above.

3.4.2 Has the SGP reduced the stabilizing effect of public finances?

The stabilizing role of public finances requires that the government budget operates as a buffer against fluctuations in aggregate demand, smoothing the business cycle and supporting economic growth during downturns. This function is related to the operation of automatic stabilizers. Automatic stabilizers are features of tax systems and spending regimes, such as progressive tax rates or unemployment benefits, which lead to an automatic reaction of budgetary flows to economic fluctuations. In addition, governments can take discretionary policy measures to counteract cyclical fluctuations in downturns, leading to a ratcheting-up of public spending.

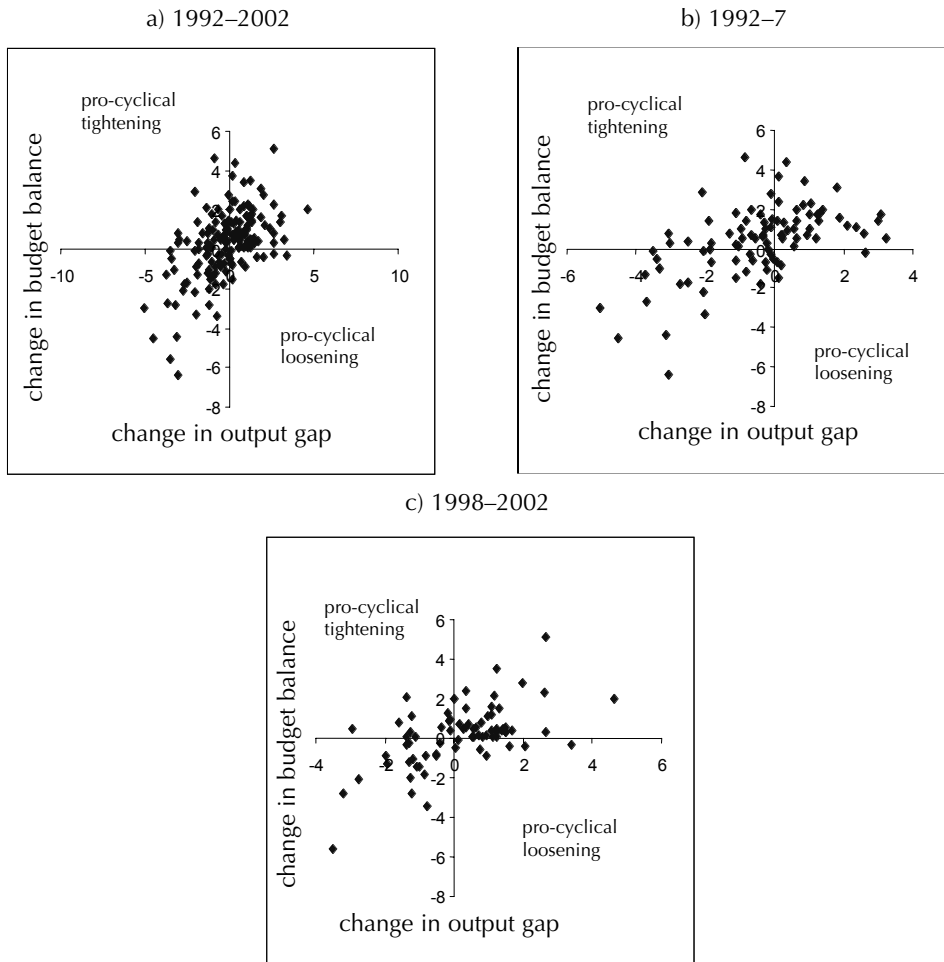
Figure 3.1 presents a graphical assessment of the cyclicity of public finances in the EU.¹¹ The three panels show the annual changes in the budget balance, measured as a share of GDP, and corresponding changes in the output gap. With counter-cyclical fiscal policies, the observations should be concentrated in the lower left and upper right quadrant, indicating that deficits expanded dur-

10 The only exception is private consumption growth, which is somewhat lower than average performance before a revenue-based adjustment strategy is launched.

11 There are several papers documenting the cyclicity of public finances in industrialized countries, such as Fatás and Mihov (2003a), Lane (2002), and Hercowitz and Strawczynski (2001); Galí and Perotti (2003), Hallerberg and Strauch (2002), Melitz (2002) and Wyplosz (2002) estimate similar models for European countries.

ing downturns and contracted during upswings. Panel (a) shows that this was certainly not always true over the total period considered. We see a number of observations (about one-fourth) with output growth falling below potential and deteriorating balances. In 40% of the cases, budget balances were improving when output was growing above trend. About one-fourth of observations, however, are associated with a tightening of the budget balance and output growth falling below trend (upper left quadrant), and one-tenth of observations with deteriorating balances while output was growing above trend (lower right quadrant). Thus, public finances seem to have been to some extent pro-cyclical in the EU over the last decade, and particularly so during economic downturns.¹²

Figure 3.1 Cyclicity of budgetary balances



Source: Authors' calculations based on AMECO data base

12 Gali and Perotti (2003) argue, in contrast, that fiscal policies in European countries were more pro-cyclical before 1992.

One potential explanation for this is that EU governments engaged in fiscal consolidations regardless of the business cycle before 1998 in order to qualify for EMU membership. To pursue this point, we separate the sample period into two, one before and one after 1998. Comparing panels (b) and (c) of Figure 3.1, we see that indeed most of the observations in the upper left quadrant fall into the pre-1998 period. One-third of all observations during that period are characterized by pro-cyclical tightening. This confirms the observation that the link between fiscal policy and output growth in Europe became weaker in the 1990s compared with the 1980s, reported by von Hagen et al. (2001).

There are fewer cases of pro-cyclical policies after 1998. In 16% of all observations fiscal policies were tightened during downturns. This equals almost exactly the share of observations (15%) where fiscal policies were loosened when growth was above trend. Only two of the countries tightening fiscal policies during the recent economic downturn had a fiscal deficit which would immediately bring it close to the 3% reference value. These are Portugal, which had to correct its excessive deficit in 2002, and Italy, which incurred a deficit above 2% of GDP in 2001. Thus, from our sample there is little evidence that the SGP has undermined the operation of automatic stabilizers. Given that most EU member states did not pursue very restrictive fiscal policies since the start of Stage 3 of EMU, as we have shown in Section 3.2, this finding does not come as a surprise. The Portuguese case, however, indicates that fiscal policies, at least in small countries, may indeed become distinctively pro-cyclical when the 3% reference value for the deficit becomes binding.

3.5 Does sustainability need growth?

The previous section was mainly concerned with the short-term developments related to consolidation efforts.¹³ We now shift the focus to the longer-run relation between public finances and economic performance.¹⁴ The main aspects are, first, the contribution of long-run economic growth to fiscal sustainability and, second, the impact of the quality of public finances on trend economic growth in the EU.

3.5.1 Long-term growth and sustainability in the EU

As discussed in Chapter 2, the sustainability of public finances focuses on the ratio of nominal public debt to nominal GDP. This ratio rises (falls), when the growth rate of nominal government debt exceeds (is less than) the sum of the rate of inflation and the growth rate of real GDP. Since inflation in EMU is set by the single monetary policy and, hence, cannot be influenced by national governments, the latter can bring the debt ratio down in two ways, by curbing the growth rate of nominal public debt, i.e. fiscal consolidation, and by promoting real GDP growth. Here, the importance of these two alternatives for the development of the debt ratio in EU countries is analysed. The relation between real GDP growth and the increase in public debt can be captured by the following indicator:

13 Although it should be noted that consolidation efforts lasted for several years and therefore some figures may even provide a medium-term perspective.

14 The following section draws on von Hagen (2003).

$$C_{it} = 100 * \left(\frac{1 + \beta_{it}}{1 + \gamma_{it}} - 1 \right) \tag{3.7}$$

where β is the growth rate of nominal debt at time t in country i and γ is the growth rate of real GDP. Thus, C_{it} is a measure of the contribution of real GDP growth to the development of the debt ratio compared with the contribution of nominal debt growth. If C_{it} is smaller than zero, real GDP growth exceeds nominal debt growth and the change in real GDP contributes more to the development of the debt ratio than nominal debt growth.

Figure 3.2 plots five-year averages of this measure against the five-year averages real GDP growth rate. Averages over five years are used in order to filter out cyclical movements and capture the trend growth rates. The figure shows that the contribution rate is inversely related to real GDP growth. Nominal debt growth typically exceeded real GDP growth in our sample, when the real growth was low. This was mainly the case before 1998. In contrast, nominal debt growth stayed below real GDP growth, when the latter was high.

Figure 3.2 Real GDP growth and its contribution to debt developments, average values for 1992–7 and 1998–2002 (%)

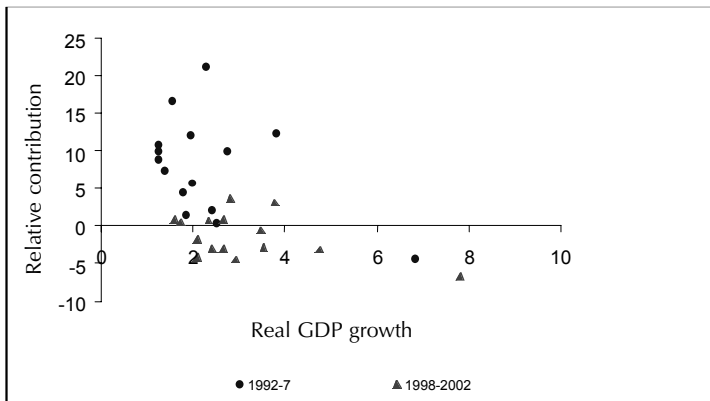
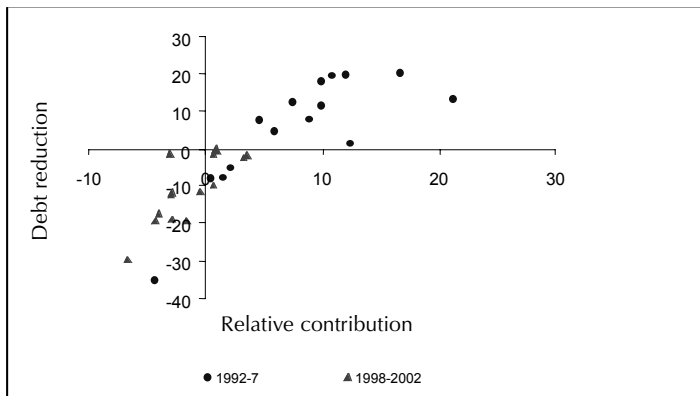


Figure 3.3 Contribution of growth to debt developments and debt reduction, average values for 1992–7 and 1998–2002 (%)



Notes: Debt is measured as share of GDP. The relative contribution rate of growth and debt is computed according to equation (3.7) in the text.

Source: Authors' calculations based on AMECO data base

An important pattern emerges when one plots the relative contribution of growth against the change of the debt ratio achieved over the respective five-year periods; see Figure 3.3. In all cases where a significant reduction of the debt ratio was achieved, it was predominantly due to strong economic growth. No EMU country achieved a significant reduction in the debt ratio without strong economic growth. In other words, while budgetary discipline is a necessary condition for the reduction of public debt, the experience of European countries indicates that it is not sufficient. Maintaining and improving the sustainability of public finances requires a sufficiently high real growth trend.

3.5.2 Quality of public finances and long-term growth in the EU

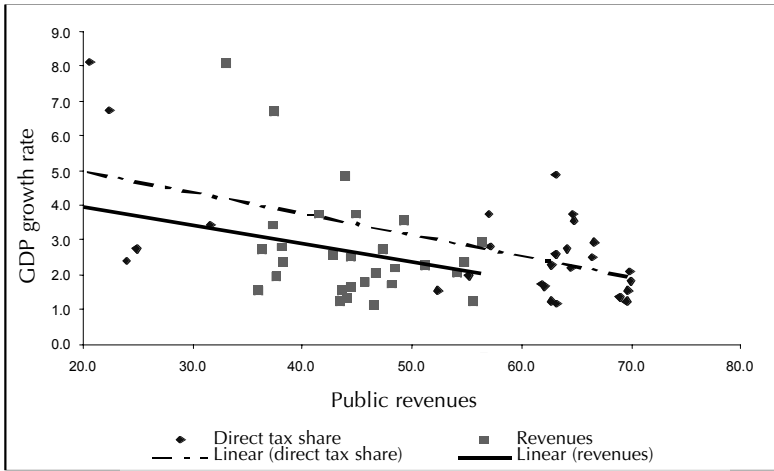
Growth theory suggests that fiscal policy affects the growth trend of an economy in various ways. Shifting taxation from factor incomes to consumption and shifting the non-productive uses of public expenditures to spending that supports private-sector production, such as public investment and R&D expenditures, have persistent positive growth effects. Empirical evidence in this area is still scant and suffers from considerable data and methodological problems. Nonetheless, there is growing evidence supporting the validity of these claims.¹⁵

To pursue this issue, we first look at the correlation between the overall tax burden and the structure of public taxes and trend real GDP growth. Figure 3.4 plots the average growth rates for the EU countries against the average tax burden and the share of direct taxes over the pre- and post-1998 periods. To get a full picture of public revenues, our measure of direct taxes includes social contributions. The figure shows a clear negative association between the tax burden and the trend growth rate. Similarly, growth is lower where the share of direct taxation is higher. This is consistent with standard arguments in growth theory suggesting that the distortionary effects of taxes on factor incomes reduce economic growth. The implication is that policies increasing total taxation and, in particular, the taxation of factor incomes, are detrimental to long-run growth, and, therefore, reduce the sustainability of public finances in the long run.

Figure 3.5 considers the link between trend growth and the structure of public spending in the EU economies. It indicates a negative relationship between the share of social transfers in GDP and long-term growth. This suggests that the adverse incentives resulting from generous social benefit systems weaken economic growth. Furthermore, the figure shows the relationship between the share of public investment and economic growth. The true productivity impact of public investment is certainly hard to capture, and other spending items can have positive growth effects, too, such as the salaries of academic teachers through their impact on human capital formation. Nevertheless, we take the share of public investment as a rough indicator for the productive content of government expenditures. The figure shows that a higher share of public investment is positively associated with trend real growth in EU countries over the last decade. The implication is that fiscal policies reducing the generosity of welfare systems and shifting expenditures towards productive uses can spark higher trend growth.

15 See Bleaney et al. (2001), Cashin (1995), Tanzi and Zee (1997), Fölster and Henrekson (1999), Kneller et al. (1999), Kneller (2000), Gemmel and Kneller (2000, 2002), Brückner and von Hagen (2002) and Romero and Strauch (2003).

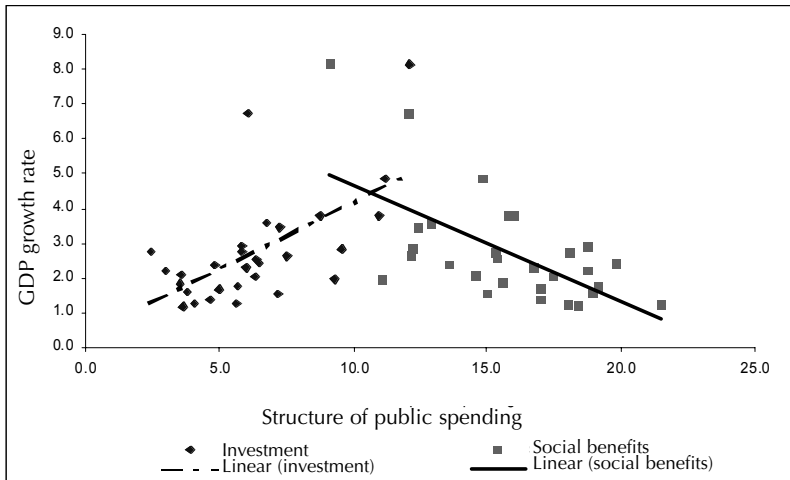
Figure 3.4 The size and structure of public revenues, 1992–2002



Notes: Direct tax share indicates the ratio of direct tax revenues to total revenues. Revenues are measured as share of GDP. All variables are indicated in percent and measured as five-year averages.

Source: OECD Economic Outlook dataset.

Figure 3.5: Social Benefit spending and the share of public investment, 1992–2002



Notes: Investment indicates the ratio of public investment to total expenditures. Social benefits are measured as share of GDP. All variables are indicated in percent and measured as five-year averages.

Source: OECD Economic Outlook dataset.

Obviously, the strength of this evidence is limited by the small number of observations. Nevertheless, putting the various facets together adds up to a message with important implications for fiscal policies in Europe. Specifically, fiscal policies can affect the sustainability of public finances by their impact on long-term economic growth. Reducing the burden of public levies – taxes and social contributions – on factor incomes, reducing the share of transfer payments in GDP and shifting public spending to productive uses have been successful strategies in Europe to put economies on higher growth trends.

3.6 Conclusions

This chapter has reviewed the experience of EU member states with the European fiscal framework so far. The first section asked how much consolidation actually occurred under the SGP. Accounting for the impact of economic growth and changes in interest rates on public-sector deficits, economic growth was the main source of fiscal consolidation during the boom years 1999–2001. In fact, with stronger fiscal discipline, growth could have contributed more. Due to the lack of fiscal discipline in some countries, budget balances went beyond the 3% limit during the downturn in 2002, and countries gradually became less willing to conduct restrictive fiscal policies.

The next subsection looked at the impact of fiscal policy on short-term economic growth. We find that expenditure-driven consolidations are associated with stronger GDP growth compared with revenue-based strategies, confirming the empirical results from much broader samples of countries. We also find that fiscal policies in the EU appear to have become pro-cyclical during the 1990s. Since the start of EMU, this tendency has become somewhat weaker. Given that, as shown in Section 3.2, the SGP did not lead to overly restrictive fiscal policies, there is no indication of a more pro-cyclical bias in EMU until now. However, this may change when more countries approach or exceed the 3% threshold, and the fiscal framework is maintained in its current form.

The final section showed that sufficiently strong trend growth of real GDP is a necessary condition for the sustainability of public finances in EMU. Countries with low trend growth over the past five years, most notably Germany and France, did not achieve significant improvements in their public debt burdens. Only those countries that achieved strong trend growth rates managed to reduce their debt burdens by sizeable amounts. Lowering the tax burden and shifting taxes away from factor incomes, reducing the generosity of welfare benefit systems and focusing spending on productive areas are strategies conducive to higher trend growth in European countries.

The observation of important relationships between the quality of public finances and economic growth in the short and the long run implies that the consequences of a government's fiscal policy for the sustainability of its public finances go far beyond the simple link between annual budget deficits and the stock of public debt. Since two-thirds of all consolidation episodes in the EU after 1992 were associated with higher taxes *and* higher transfer spending, the danger of creating a contradiction between short-term budgetary discipline and long-term sustainability of public finances is a real one in EMU, which should not be ignored.

Furthermore, an unqualified call for budgetary discipline, irrespective of how

the consolidation effort changes the quality of public finances, could be counter-productive, if it leads to a reduction in long-term growth prospects. Finally, insisting on policies that keep the budget close to balance can undermine the sustainability of public finances, if it prevents governments from undertaking reforms of their tax and welfare systems and labour market policies, which might lead to greater deficits on impact but put the economy on a higher growth path in the longer run.

The main insight from these results is that the fiscal framework of EMU should give sufficient weight to these qualitative aspects of public finances and some priority to long-term growth, without a loss of institutional credibility. The complexity of the issue implies that whether or not a country's fiscal policies are compatible with sustainability in a given period cannot be judged on the basis of simple numerical rules for annual deficit and debt ratios.

4 Dead Rules or Living Bodies to Maintain Sustainability

4.1 Introduction

The difficulties in the implementation of the SGP described in Chapter 3 have raised many criticisms of the current rules. These criticisms have been focused on the inappropriateness of strict rules for budget deficits, as well as on the poor performance of the enforcement procedures that have been put in place. As a result, the SGP has seen its foundations weakened to a point where its credibility has been damaged and reform is needed. Most of the proposals for reform highlight the rigidity of the current rules and suggest ways in which the implementation could be made more flexible. While some of these proposals are of a technical nature, others question the economic benefits of imposing fixed numerical limits on government borrowing in principle.

The need for reform was recognized by the European Commission in a document dated November 2002 that includes a list of principles to guide the reform process as well as concrete proposals answering some of the recent criticisms of the SGP. This proposal follows the Code of Conduct approved in July 2001 that already incorporated some important qualifications to the original rules of the SGP. While most of these qualifications were technical in nature (for example, taking into consideration cyclically adjusted balances when assessing medium-term budgetary plans), they also opened the door for changes that could have serious implications for the implementation of restrictions on fiscal policy among member countries.

In this chapter we summarize the principles and logic of these reform proposals, starting with the one presented by the European Commission to the Council and the European Parliament (November 2002). All the reform proposals we summarize in the next section are based on the notion that numerical rules for fiscal policy are in principle adequate to ensure sustainability. In the second half of this section we broaden our analysis and consider the question of whether numerical rules are the best way to constrain fiscal policy. We suggest that rules cannot escape the trade-off between flexibility (i.e. adaptability to economic circumstances) and simplicity and implementability, regardless of how they are designed. A similar trade-off has long been resolved in the domain of monetary policy by creating institutions that exercise judgement on policy decisions but are not subject to the type of incentives that create costly biases in terms of high inflation. In EMU, this institutional approach is reflected in the independence of the ECB and the European System of Central Banks (ESCB). Following this parallel, we present a set of ideas or principles that should guide

such an institution in the fiscal policy domain to guarantee that the objectives of sustainable public finances are achieved while allowing for flexibility to react to changing economic conditions. This line of thought leads us to Chapter 5 where we present a detailed proposal for institutional reform of fiscal policy in the EMU.

4.2 What is an optimal fiscal rule?

The concept of restricting fiscal policy behaviour through rules is not new. Many US states impose restrictions on government deficits and debt, and there is a growing number of countries where different forms of numerical constraints are discussed or implemented.¹ What are the principles under which such rules should be designed? At this stage we want to be broad in our analysis, rather than focusing narrowly on the problems that the SGP has generated. We limit ourselves for now, however, to the analysis of numerical rules constraining the discretion of policy-makers.

When thinking about the principles upon which optimal rules might be based, it is useful to separate two dimensions: efficiency and enforceability. Efficient rules are those that meet the given objectives while minimizing any costs or side-effects that they might impose on the economy. Enforceable rules are those that can be effectively imposed on the relevant policy-makers.² Rules are about constraining discretion. Constraining discretion can be justified on several grounds, but it comes at the cost of reducing the flexibility of fiscal policy and its ability to react to economic shocks. To make sure that a rule can achieve its goals at minimum cost, we want it to follow certain principles.

1. Consistency with its stated goals

While this may seem obvious, it requires a clear understanding of the reasons why fiscal policy should be constrained. In Chapter 2, we have pointed to several motivations why this might be the case. Is it to ensure the sustainability of public finances, or is the goal a broader one that seeks restricting politically motivated changes in fiscal policy?³ If so, a limit to the debt burden as a ratio to GDP would be appropriate. Or is the goal to restrict politically motivated changes in fiscal policy? In that case, limits to the size of the deficit might be required. Or is it a matter of ensuring an optimal combination of fiscal and monetary policies both within the national economies and across Europe? In that case, limits to the size of the deficit and spending might be used to prevent spill-overs and interference with monetary policy. Optimal rules must therefore differ according to the ultimate goal. What is clear is that the rule must set limits that become binding on those occasions where the use of discretion by fiscal policy-makers is considered in some sense to be sub-optimal. Thus, we need a clear definition of what constitutes a sub-optimal (or undesirable) use of discretion and the rule must be adequate to address that specific problem.

1 For a review of deficit and debt rules prevailing in the US and their effectiveness see von Hagen (1991, 1992a).

2 Some of these principles originate in Kopits and Symansky (1998). An alternative sets of principles is summarized in Buiters (2003), Buti et al. (2003) and OECD (2002).

3 In Chapter 2 we presented the arguments why constraining fiscal policy might be optimal and how this relates to the notion of debt sustainability. Also, for a general discussion on the different reasons to constrain fiscal policy, see Fatás and Mihov (2003a,b).

2. Credibility

Regardless of the exact type of sub-optimal discretion a rule aims at, it must be credible and well understood by economic agents to be effective. Credibility requires consistency with the general goals of fiscal policy, i.e. it must be clear that violating the rule can never be in the best interest of fiscal policy-makers. Credibility also requires transparency in the formulation and implementation of the policy rule. Deviations from the rule must be observable and verifiable.

3. Adaptability to changing circumstances

In order to limit the costs of constraining discretion, a rule should leave as much flexibility as possible for fiscal policy to adapt to changing economic circumstances. In the context of rules for deficits and debt, this concerns in particular the ability of budgetary policies to play their desired role of macroeconomic stabilization. While there is no disagreement on this principle, the natural trade-off that exists between constraints and flexibility leads to a debate on how to balance both principles.

4. Clarity and transparency

Within the set of rules that achieve the desired objectives, a simple rule is always preferable to a more complex one. Indeed, this requirement is probably implicit in some of the previous ones, as rules need to be well defined and simple to be understood, to be (seen to be) implemented correctly and to be credible.

Next, one must also think about the processes and the principles on which implementation and enforcement of a fiscal rule will be based. The rule itself, its process for implementation, the penalties in case of violations, have to be defined and made sufficiently precise, so that the enforcement process is done effectively (i.e. the limits or constraints imposed by the rule are indeed implemented) and at the minimum possible cost.

Monitoring compliance with the rule should be *ex post*. That is, it cannot only be about presenting budget plans that are in accordance to a rule but it must include an assessment of how well these proposals were delivered. Budget plans are subject to many assumptions about future economic conditions, some of which are uncertain and will turn out to be wrong. Unless the review process is *ex post*, enforcement will be weak, as governments will find arguments based on changing economic conditions to justify deviations from the plan.

Furthermore, monitoring compliance should be the task of an independent and impartial body which is transparent, can impose sufficiently severe penalties on policy-makers defecting from the rule and cannot be overruled by any other institution. There should be no expectation that different standards might be set for different people, or that warnings and sanctions could be blocked after having been issued. Finally, and related to the previous point, a rule should not be easily amendable. That is to say, the spirit of the rule and compliance cannot simply be achieved by frequent changes to the principles and mechanisms underlying them.⁴

4 Our discussion on enforceability is similar to Buti et al. (2003) and Inman (1996).

The wish to improve efficiency and enforceability can be found behind most of the recent reform proposals for the SGP. However, it is important to note that many of the principles listed as requirements for optimal rules are interlinked and cannot easily be separated. For example, transparency cannot be achieved unless the enforcement process is credible and consistent. The same is true for simplicity. A rule based on a numerical limit for budget deficits satisfies the requirement of simplicity; but if there is added flexibility in its interpretation when it comes to enforcement, its simplicity is meaningless. Thus, one cannot separate the enforcement process from the rule itself.

Finally, although there is not much disagreement about most of the principles above, there are significant trade-offs between them, which are often neglected in the current debate. These trade-offs require compromises along some dimension. Current reform proposals differ in the emphasis given to the different criteria and their willingness to sacrifice some of the criteria in order to obtain better outcomes in others. An example is the tension between simplicity and adaptability to changing economic circumstances. Those who advocate a more flexible rule than the current framework implicitly argue for rules that are less simple and more difficult to define or implement. We come back to these points later in the chapter.

4.3 Is the SGP an optimal fiscal rule?

In order to illustrate the optimality principles we have just described, we now ask whether the SGP fits them, and, if not, in which dimensions the SGP could be improved. Among the principles described in the previous paragraph, it is clear that the SGP emphasizes the notion of simplicity. The targets for deficits and debt are made to leave as little room for interpretation as possible. Moreover, the SGP imposes uniform limits on all member states, regardless of any differences in their long-term growth prospects or the actual level of debt. Regarding enforcement, there is a contradiction between a seemingly straightforward comparison of actual levels of deficit and debt with the ceilings defined in the Maastricht Treaty, and the more complex process subject to political influence that has emerged in practice.

We now list the most important points of contention in the SGP, within the context of our principles.

1. The goals of the SGP are not transparent

As discussed in Chapter 2, the original goal of the SGP is to safeguard the sustainability of public finances in EMU. The SGP imposes its rules to prevent the ratio of public debt to GDP from rising to unsustainable levels. In the meantime, however, the goal has become less clear. The interpretation and implementation of the fiscal policy framework have been moving away from the simple objective of sustainability towards a more ambitious goal of ensuring that all countries follow sensible (if not optimal) fiscal policies.

The resulting lack of a clear and unambiguous definition of the ultimate goal of the current fiscal policy framework has led to diverging opinions as to whether the SGP is adequate for what it is trying to achieve. For those who see the ultimate goal as sustainability, the current framework seems too intrusive and aggressive. For those who see the more ambitious goal of enforcing optimal

fiscal policies, the rules fall short of preventing policies with negative consequences for the economic performance of EMU. For example, the limits on deficits cannot remove pro-cyclical fiscal policy in good times unless one can argue that such policies are going to lead to unsustainable deficits in the future.⁵ Moreover, they will prove pro-cyclical in bad times.

Finally, and for those who seek multiple goals, the recent events have proven that it is very unlikely that one rule can achieve more than one objective. Attempts to make the rule achieve several objectives can only lead to a lack of transparency and a dilution of the original principles behind the restrictions.

2. Strict limits on deficits and debt are not flexible enough

The notion of simplicity goes against the idea of adaptability to different circumstances. Simple rules cannot take into consideration the differences in the business-cycle position, changes in growth potential, or the need for reform processes that might stretch over several years.

3. Uniform rules are inadequate relative to the final goal

The 3% deficit limit and the 60% debt limit were originally chosen to be consistent with a stable debt ratio and a trend annual growth rate of nominal GDP of 5%. With 5% growth, the increase in debt implied by a 3% deficit exactly offsets the reduction in a debt ratio of 60%. It is now clear, however, that the EMU countries did not and will not grow uniformly at a rate of 5% annually. Some countries achieved growth rates significantly above that rate; others, Germany and France in particular, achieved less than that. If nominal trend growth is 2.5%, which is likely to be the case in Germany today (i.e. 1% real growth and 1.5% inflation), the deficit must be only 1.5% of GDP to stabilize a debt ratio of 60%. Thus, slow-growing countries like Germany and France can experience rising debt ratios even if they stay below the 3% limit for the deficit. The current framework does not safeguard sustainability for these countries. At the same time, the 3% limit is excessively tight for countries with high growth trends, an issue which will be particularly contentious once the current accession countries are full members of EMU.

4. There are serious problems with enforcement of the rules

These problems start with the fact that enforcement is left to ECOFIN (with the recommendations of the European Commission), which is not an independent or disinterested body. Also, in the run-up to EMU, there were very clear penalties (entry would not be allowed) that were perceived as being large and avoidable by most members. But the system of penalties that is to be applied now still has to be tested. Given that the process by which countries are judged to be in breach of the Treaty's provisions is not completely transparent, and because different countries are perceived to have been treated differently, the SGP has suffered from a serious lack of credibility.

These shortcomings have led to a large number of reform proposals that aim at improving the SGP. Of special interest is the view of the European Commission (partially ratified in the March 2003 meeting of the Council), because it highlights the difficulty of resolving the contradictions inherent in the current framework.

5 Chapter 2 has discussed these issues extensively.

4.3.1 The European Commission's proposal

On 11 November 2002, the European Commission put forward a proposal entitled 'Strengthening the coordination of budgetary policies' that addresses some of the criticisms of the current system. Although the proposal contained in that document tries to stay as close as possible to current practice and the original spirit of the Treaty, it contains suggestions that are significant and could lead to changes in some of the fundamental features of the current system.

The Commission's proposal starts with an assessment of what went wrong with the SGP in its first three years. The main problems identified are similar to those we previously described. The first is a decline in the political ownership of the SGP by the member states. The Commission notes that the political support for the principles of the SGP has weakened considerably as a result of the failures in its implementation and the perceived lack of transparency.

Second, there are problems in establishing clear and verifiable budget objectives that take account of economic conditions. The early criticisms of the strict numerical rules focused on the fact that they do not take into account differences between countries. Among those differences, cyclical differences and differences in initial conditions (the level of government debt) were considered the most serious.

Third, fiscal policies have been significantly pro-cyclical in good times. In particular, the governments of the large countries did not take advantage of the benign economic circumstances of the early years of EMU to make progress towards the achievement of budgetary positions close to balance or in surplus. While these governments were able to stay below the 3% deficit limits, they were not disciplined enough to stay sufficiently far below the limits to withstand the fluctuations of bad times. Instead, they ran pro-cyclical fiscal expansions that made their own medium-term budgetary targets more difficult to satisfy later on.

Fourth, enforcement of the SGP has been poor. The Commission admits in particular that the system of early warnings has not been effective.

Fifth, allowing for flexibility for countries intending to undertake economic reforms has been difficult. The Commission recognizes the problem of dealing with countries that are in urgent need of reforms and where reforms could lead to a deterioration in public finances. This is, indeed, the fundamental tension between having simple rules but, at the same time, wanting to be able to adapt to specific economic circumstances.

Sixth, there remain difficulties in communication, data collection and manipulation. The Commission recognizes some technical difficulties in the quality of the data collected and the way the data are manipulated, interpreted and communicated to the general public.

Based on this analysis, the European Commission proposed a list of recommendations for reform that can be summarized in the following points.

- Add flexibility to the rules. This might be done at several levels. First, the Commission stressed the need to use cyclically adjusted variables when assessing medium-term budgetary plans. This was already introduced in the previous code of conduct and has been partially put in practice through the adoption of a unifying framework to measure potential output and the cyclical position of all EMU members. The second dimension along which flexibility is desired is to allow small deviations from the

close-to-balance-or-in-surplus rule for countries that have low debt-to-GDP ratios ('taking into consideration differences in economic conditions').⁶ Similarly, there is also recognition of the need to pay attention to the quality of public finances so that objectives go beyond numerical quantities. But the Commission has stopped short of saying how those ideas would be incorporated into specific rules. What rules specifically, how might they be enforced and with what thresholds?

- Increase political ownership. All countries must agree that sustainability is a core objective. The idea is to create the necessary political support and credibility to safeguard that objective. A clear definition of how sustainability should be measured is not included.
- Reinforce surveillance. When deviations are foreseen, there should be a system of 'early-early warnings' so that countries have enough time to react and avoid falling into excessive deficits which will be much more expensive to eliminate later on. Although not specified by the Commission, one procedure would be to introduce a system of rules that react to anticipated future deficits – in addition to imposing explicit targets for those periods.
- The Commission also recognizes that the level of debt matters when assessing the budgetary position of a country. Pro-cyclical fiscal policy in good times will be considered a violation of the budgetary requirements because it prevents governments building up a budgetary cushion against the next downturn. Debt would then accumulate over the cycle if deficits are not constrained even more severely in the future. The Commission proposes that such behaviour should meet with an appropriate response, in order to provide an incentive to reduce debt levels and to provide a cushion for future shocks. One way to deal with this problem would be to introduce a Finnish-style buffer fund – in which payroll taxes and unemployment insurance are increased and placed in a fund in an upturn, in order that the proceeds may be used to reduce those contributions in a downturn. One would imagine that such buffer funds should be administered locally, but it could be part of a new stability pact to mandate them.
- Upgrade statistics and improve communication. These proposals are very similar to those presented by Buti et al. (2003) who, among other things, suggest the following changes. First, different countries should be allowed to have different policies according to differences in each country's 'initial' state. Second, transparency should be enhanced by using structural balance targets. Third, the tendency to run pro-cyclical bias should be corrected by an early warning system and the building of 'rainy day' funds. Fourth, there should be a non-partisan enforcement through having the Commission implement rules that are ultimately set by the Council (as opposed to current practice where implementation of the rules and penalties is done by the Council).

6 This implies that small deviations, beyond the 3% deficit limit, would be allowed among low debt countries provided that the close-to-balance-or-in-surplus target was retained for the cyclically adjusted budget. But how that restriction in the cyclically adjusted budget would be applied exactly was not spelled out.

These five points effectively summarize the principles of the proposal by the Commission, with the exception of the last point that goes further than the its proposal by suggesting that more power should be given to the Commission in the enforcement of the rules.

The proposals put forward by the Commission and by Buti et al. (2003) share two important features. First, they are based on the idea that a small adjustment to the principles of the SGP will be enough to fix some of its main problems. Second, they stick to the initial numerical rules based on strict limits on budget deficits and debt as well as assessments on medium-term targets. They do add some flexibility, however, to the way in which these measures might be constructed.

BOX 4.1 The Golden Rule in the EMU context

Blanchard and Giavazzi (2002) have examined one version of this Golden Rule formulation, where capital depreciation and maintenance costs are included in the current spending component of the budget, but (net) investment expenditures are not. This is a little more restrictive than simply excluding all investment expenditures. They also suppose that current spending should be balanced, although this is not a necessary requirement. They then argue that such a scheme has three advantages:

- It is desirable to remove financial constraints from public investment, as argued above, especially if those constraints are triggered by temporary downturns or adverse shocks.
- It would introduce greater transparency in the budget, with regard to what happens to multi-year public investments and why they may get interrupted; and also because the tendency to move such projects to less accountable locations 'off-budget' would be removed.
- Not only does it make the given restrictions easier to satisfy by protecting public investment programmes, it also creates a positive incentive to substitute public investment expenditures for 'excessive' current expenditures – increasing the domestic stabilizing effects of fiscal policy and encouraging public investment where it has been run down.

The disadvantages are:

- Public investment may crowd out private capital, whereas including public investments in the budget restrictions will allow private capital to compensate for public capital. As the track record shows, however, neither is likely to happen if the social rate of return on these investments is higher than the financial rate of return – which is usually the case, since that is why public investment is needed in the first place.
- Weakening budget constraints like this reduces the pressure to lower the stock of public debt. That is true; but it does not reduce that pressure to zero since public investment is a relatively small component of the budget, and most countries have not yet exceeded their deficit limits. Moreover, we could always supplement this golden rule with an explicit debt rule. But if investment in infrastructure or in education and training facilities were to increase the rate of growth, public investment might actually reduce the debt-to-GDP ratio.

4.3.2 Other proposals for modifying the numerical rules

Several alternative proposals look at numerical rules that differ from the strict limits on deficits and debts. These proposals all regard sustainability as the main goal of the SGP, but they see the current set of rules as inappropriate to achieve this objective. These rules are perceived as too restrictive; and, although they do ensure sustainability, they do it at a cost that is too large. We can group these proposals into the following categories.

- *The Golden Rule.* The argument here is that the deficit is not what matters, but the composition of expenditures when there is a deficit. Larger deficits can be allowed only if they are the result of public investment (see Box 4.1). Thus, the Golden Rule – which is embedded, for example, in the German constitution and in the current fiscal framework followed by the UK government – says that the annual deficit should not exceed annual public investment spending.
- *Debt rules.* Since sustainability relates more to the debt burden than to the annual deficit, these proposals suggest that the focus of the fiscal framework of EMU should be on the debt ratios rather than on the deficit ratios. Debt rules would allow stronger fiscal expansions, when sustainability is not threatened. Pisani-Ferry (2002), for example, suggests that the deficit criterion might be loosened for countries with low debt ratios.⁷ Such rules are equivalent to introducing a non-linearity, which makes more stabilizing power from the annual deficit available in the safe ranges. They also create an incentive for governments to maintain a low debt ratio. Specifically, such rules would induce governments to tighten their budgets in good times to help reduce their debt ratios to a more powerful level before the next downturn. This would reduce the problem of pro-cyclical fiscal policies observed above.
- *Country-specific rules.* The 3% deficit rule, and the close-to-balance-or-surplus-target value, are arbitrary impositions and can lead to very undesirable outcomes as they do not take into consideration current conditions in individual countries. They might also make little sense in the longer run, if they lead to negative government debt. That would make little sense unless the assets accumulated this way were converted into a stabilization fund of the type operated by the Hong Kong government; or that proposed by the Swedish government commission to enhance wage cost flexibility and employment in bad times (Johansson, 2002). An alternative approach would be the Permanent Balance Rule proposed by Buiters and Grafe (2002). This is a rule based on a type of strong tax smoothing. It would avoid some of the arbitrariness of the present rules, but it does require a more aggressive use of the tax system.
- *Cushion funds.* Related to the last point, governments could improve the stabilizing function of the budget by maintaining explicit tax smoothing or stabilization funds. Finland has used such funds in recent years. The funds would be automatically built up during good times and depleted during bad times.

7 CESifo (2003) suggests another scheme in which the higher-debt countries are simultaneously restricted to deficit ratios lower than the standard 3% limit. This, however, would make the current Stability Pact even more difficult to enforce, and is not considered here.

Since they stick to the rules-based approach of the current fiscal framework of EMU, these proposals share some of the assessments spelled out by the European Commission regarding the problems of the current SGP. They simply go further than the Commission in their recommendations because they are not constrained by the Treaty and they suggest reforms that will require substantial changes in the Treaty.

4.3.3 Potential impact of the different proposals

Would any of these proposals have made a big difference in terms of the actual fiscal policy?

- *The Golden Rule.* The switch to the Golden Rule would make rather little difference in practice. Preliminary calculations by Blanchard and Giavazzi (2002, Table 1) suggest that the current sinners, France, Germany, Italy and Portugal, would be left with short-run Golden Rule deficits of, respectively, 1.2%, 3.7%, 1.9% and 1.9% of GDP in 2002, on their definition of the rule. Those deficits would then become 2.2%, 3.3%, 1.7% and 3.3% in the long run. Thus Germany and Portugal would continue to be sinners – although Portugal might have been able to delay its current sanctions for a while. Germany would also still be a sinner in the short run; and the other two problem cases (France and Italy) would continue to have deficits pretty close to the 3% limit⁸ and well away from their target values (and therefore remain vulnerable to future shocks). Thus, on current information, the Golden Rule approach might relieve some short-run restrictions on the budget. But the main effect would just be to delay a violation of the Treaty.
- *Cyclically adjusted budgets.* Several proposals recommend using structural (cyclically adjusted) budgets rather than actual budgets for assessing the annual deficits under the SGP. This would remove some of the more volatile elements of aggregate demand from the SGP calculations; and help focus policy on removing structural imbalances while maintaining long-run sustainability. It would also prevent pro-cyclical fiscal policies, when negative shocks, which are transitory and do not threaten the sustainability of public finances, hit the economy. Third, it may help eliminate any expansionary bias in the balance of fiscal policies by making the need to balance over the cycle more explicit. Fourth, and perhaps most important, it would help eliminate the problem that discretionary fiscal policies are subject to long and variable lags, and rather uncertain impacts on economic performance. Taylor (2000) recommends that discretionary fiscal policies are avoided for this reason; and that governments should rely on a combination of automatic stabilizers, designed to be as powerful as possible, and discretionary stabilization – at the Euro level – through an active monetary policy.

The only existing empirical study considering the use of cyclically adjusted deficits under the SGP, Hughes Hallett and McAdam (1999), shows that this would cause fewer episodes of fiscal tightening. As a

8 All other countries show small surpluses on this definition of the deficit ratio (Austria excepted).

result, growth would be less damaged by a cyclically adjusted criterion. To the extent that investment depends on future expected incomes, a somewhat higher output capacity could be maintained under such a regime. But the effects would be small, since targeting actual balances over the medium term must amount to the same thing unless violations of the SGP are frequent. A more tangible advantage would be that focusing on the cyclically adjusted budget allows tax changes or expenditure cuts to be phased in instead of being imposed each time the deficit threatens the 3% limit. Phasing-in may have political advantages, which could be a significant gain if the legitimacy of restraints imposed by some central authority should continue to be a matter of tension.⁹

- *Debt rules.* A truly binding SGP should already produce some of the effects expected from a debt rule, if monetary policy is tight. Since a low-debt country has lower interest payments, its government can afford a stronger fiscal expansion in an economic downturn without exceeding the 3% limit, than the government of a high-debt country with larger interest payments as a proportion of GDP. The main question is, therefore, whether it is worth enhancing these effects by adding an element depending on the debt level to the current deficit rule. For example, one could augment the deficit rule as follows:

$$d = 3\% + 0.1(40\% - b) \text{ if } b < 40\%, \\ 3\% \text{ otherwise}$$

where d is the deficit ratio and b is the debt ratio in per cent. This would increase the permissible deficit to 4% for countries with debt ratios of 30%, to 5% for countries with debt ratios of 20%, and so on. In practice, however, this would make very little difference in current circumstances. The only EMU countries to benefit would be Luxembourg and Ireland, which have been 'close to balance or in surplus' anyway and are unlikely to violate the 3% limit as long as current growth rates hold up. Even if the critical value was raised to 50%, it would help only Finland, which is running surpluses at the moment. More generally, debt rules are unlikely to be effective, chiefly because they benefit those who do not need weaker fiscal constraints. In a conventional rules-based regime, however, they provide an important incentive for restraining expenditures that ought not to be neglected. If deficit limits can be extended when debt ratios are low, governments will have an incentive to keep their debt ratios down as an insurance policy against unfavourable circumstances in the future. That will act as a brake on additional expenditures. It will also add an element of symmetry since, in order to maintain extended deficit limits in the future, governments will want to restrict their budgets in good times so as to reduce their debt ratios before the next downturn. That would reduce (if not remove) the temptation to loosen expenditures pro-cyclically in good times, and encourage the creation of rainy-day funds. The inability of policy-makers to prevent themselves from spend-

9 The real difficulty with this proposal will be to secure agreement on the correct calculation of the trend underlying the cyclical adjustments of the budget (see Section 2.2). A graphic illustration of this problem is given by tracking the revisions to the estimates of the cyclically-adjusted budgets for one country in one year in successive issues of the OECD *Economic Outlook* (for example).

ing new revenues as they come in is thought to be one of the main reasons for the failure of the SGP.¹⁰

- *Sticking to cautious targets.* The official literature (e.g. European Commission 2001, 2002a,b) and much of the academic analysis argue that the key to linking the SGP to optimal fiscal policies is that governments stick to sufficiently cautious targets for the deficit ratio especially in good times, and let automatic stabilizers work freely in bad times without any further, discretionary fiscal interventions.¹¹ In this way, the budget would offset output fluctuations by as much as 11–25% in the euro area as a whole (Brunilla et al., 2002), without breaching the deficit limit.

There is, however, an important practical difficulty with this argument. First, four countries have already gone, or are about to go, beyond the 3% limit in the first four years of EMU. This may have been because fiscal policy failed to stabilize the cycle (causing a further deterioration in the budget); or because fiscal discipline was too weak in the years of strong economic growth to stabilize the budget. Either way, relying on automatic stabilizers appears to have fallen short of what is required. In fact, given the current deficit targets, which were set to achieve balanced budgets over the medium run, the probability of breaching the 3% deficit limit is between 8 and 10% every year. This means that the observed outcome of four violations in four years is about what we should expect to happen on average (see Box 4.2).

Box 4.3 examines generally whether it is possible to get the result we want – that is, a stabilized cycle without breaching the SGP's budgetary limits – by creating stronger stabilizers. Evidently two separate components are involved here: (a) the possibility of strengthening the budget multipliers, so that a given deficit has greater stabilizing power; and (b) increasing the fiscal responses to shocks (the automatic stabilizers) so that the fiscal adjustments around the cycle become larger. Together they would provide stronger automatic stabilizing effects on national income. But whether they would create larger or smaller deficits at the same time is an open question which depends on whether the smaller deficits, made possible by stronger budget multipliers and a more stable cycle, actually outweigh the larger deficits created by having larger adjustments around that cycle. The general answer appears to be that they would not. To get them to do so requires sufficient deregulation and market flexibility on the supply side.¹² That is not a feature of the European economies at present. Consequently, to rely on more effective automatic stabilizers alone is not a feasible option.

A second point is that both the budget balance and the cycle react differently to shocks in different sectors of the economy. Van den Noord (2000) and Brunilla et al. (2002), for example, show that different automatic stabilizers apply for different tax and expenditure categories. It would therefore pay to redesign the SGP to focus on and promote the most responsive elements – both so that smaller budgetary interventions could be used to get the same degree of

10 See European Commission (2002d); von Hagen et al. (2002a); and the evidence in Chapter 3.

11 Evidence that this may not be enough to stabilize the cycle and keep budget deficits below 3% of GDP is given by Kiander and Viren (2000), Hughes Hallett and McAdam (2003) and our experiences so far.

12 This result is consistent with Buti et al. (2003), who find that there is no conflict between welfare (stabilization) and fiscal restraints provided that the distortionary effects of taxation fall below a certain threshold.

BOX 4.2 The probability of exceeding the 3% deficit limit in any given year

Eichengreen (1997) warned that the automatic stabilizers may not be strong enough in Europe to prevent periodic violations of the 3% limit, unless an adequate 'cushion' was created between target and threshold. Eichengreen and Wyplosz (1998) provided estimates of the probability of hitting the 3% limit. Setting the target at budgetary balance, Barrell and Dury (2001) and Hughes Hallett and McAdam (2003) find that the probability of exceeding the 3% threshold would be either less than 2%, or between 8% and 10%, using stochastic simulations and the estimated distribution of historical shocks.¹³ However, the Barrell-Dury study has a reference position with balanced budgets; which is to imply that all governments are obliged to meet their budget targets exactly, in every period, in the absence of shocks. Policy makers are not allowed to trade-off budgetary discipline against not meeting that target on average in each period, if the latter would allow smoother budgets or extra growth.

The Hughes Hallett and McAdam study treats the deficit target as something to be achieved over the medium term, but not necessarily in every period if there is some advantage in permitting a deviation in the short term. In that case, the extent to which the 'close to balance or in surplus' target is achieved in any particular period, in the absence of shocks, is subject to choice. But in the longer term, that is over the cycle, it must hold. Taking this to be the purpose in having medium term targets in the first place, and also the reason why we allow policy makers to choose their short term deficits flexibly (as long as they remain below 3% of GDP), then this more flexible target approach must be the more realistic one.

Hughes Hallett and McAdam's results therefore show that the probability of exceeding the 3% limit is likely to be around 8–10% for each country. This result also matches our experience so far. An 8% probability among independent countries would imply that each country will violate the 3% limit one year in 12 on average; or that a group of 12 such economies should expect to have one country violate that limit each year.¹⁴ As it is, we now have four countries which have either exceeded or come close to exceeding the SGP's 3% limit within the first four years of monetary union. Hence 8% seems to be about the right probability level for a breach of the SGP as it stands.

stabilization, and so that we get more stabilization per unit of intervention. Design work of this kind has never been done: the SGP, as it stands, imposes an arbitrary set of restrictions from the outside.

In this context, it would also pay to redesign the SGP to be more forward-looking with respect to its deficit or debt targets. Earlier we pointed to the need for 'early-early' warnings. Rather than waiting for an excessive deficit or debt

13 Of course, if budget deficit target values greater than zero are allowed, as they were across most of the EU countries in the 1990s, then the probability of an excessive deficit will be considerably higher than this: perhaps 30% or more according to Eichengreen and Wyplosz (1998), based on the behaviour observed at the time.

14 The euro countries are not independent in this respect of course. But their correlations with the common cycle are probably in the range 0.2–0.5 (Frankel and Rose, 1998), which means the correlations with each other are not very high. The lower limit of this probability band is a reasonable estimate for individual countries, therefore.

ratio to emerge, as now, it would be helpful if the new Pact could recommend (or impose) alternative paths in which tax and spending policies are required to adjust in anticipation of an excessive deficit or debt level that would predictably take those quantities away from their medium-term targets. That, of course, would require a large measure of judgement.

BOX 4.3 Relying on stronger automatic stabilizers and the role of market flexibility

Under what circumstances could we expect the cycle to be smoothed without the budget deficit being destabilized? Would stronger automatic stabilizers allow that? The key point is that the budget itself is largely endogenous. In fact, the automatic stabilising action of fiscal policy consists of two parts: (1) the stabilizing effects of changing tax yields and social (unemployment) expenditures which vary counter-cyclically; and (2) the destabilizing effects of those counter-cyclical movements on the budget balance itself. These two components are not independent of each other. Stronger automatic stabilizers would stabilize the cycle more, and therefore preserve stronger revenues and smaller expenditures in a downturn – but take more out of the budget to do so. Conversely, stronger automatic stabilizers in a boom would mean weaker revenues and larger expenditures than otherwise – but would put more into the emerging surplus. Whether the budget is then net stabilized or destabilized depends on whether the stabilization effect on the cycle is stronger than the destabilizing effect on the budget. That is, on whether the direct effect of the budget on the cycle is larger than the direct and indirect effect of income changes on the budget. There may be circumstances when it is. But it may be that the multipliers on the cycle are smaller than the multipliers on the budget. In that case it will not be possible to stabilize both the cycle and the budget; and we will have to choose between having the cycle and employment stabilised to within certain limits, or having the budget stabilized within certain limits. This box therefore determines the conditions under which such choices have to be made. Those choices turn out to depend on the need for deregulation and supply side flexibility.

Consider a simple aggregate demand/aggregate supply model of a single country in a currency union:¹⁵

$$y^d = \phi_1 d - \phi_2 (i - \pi^e) - \phi_3 \pi - \phi_4 y + \varepsilon_d \quad (\text{A1})$$

$$y^s = \omega(\pi - \pi^e) + \varepsilon_s \quad (\text{A2})$$

Equation (A1) is an IS-curve in which aggregated demand, y^d , depends on the budget deficit as a proportion of GDP d ; the real interest rate ($i - \pi^e$); and a demand shock, ε_d . Assuming our country to be small compared with the rest of the monetary union, there will be no significant impact from this economy on the union as a whole. Consequently, y^d is also affected by domestic competitiveness relative to...

15 Despite its simplicity, this is a model that is widely used for analysing problems of this kind: Blanchard 2000; Brunila et al. 2002. It is derived in detail in Artis and Buti (2000) and Buti et al. (2001).

BOX 4.3 continued

...the rest of the union, $\phi_3\pi$, and domestic absorption, ϕ_4y . We take all variables to be measured as deviations from their long-run equilibrium values, and all parameters to be positive.

Equation (A2) is a supply function, where supply, y^s , depends on inflation surprises $(\pi - \pi^e)$ and a supply shock, ε_s . Fiscal responses, or automatic stabilizers, however, usually increase with the size of the government sector, the size and progressivity of the tax base, the generosity of the social support and unemployment benefit programmes – and the sensitivity of social or unemployment benefits to the state of the cycle. Hence, we write

$$d = -\alpha y + a \text{ where } \alpha = (t - g) \tag{A3}$$

and where t is the average tax rate, and g is total government expenditures as a share of GDP. If we wish to see how the economy will perform with automatic stabilisers allowed to play freely, the discretionary part of policy must be ignored ($a = 0$). Then, to increase the automatic stabilizing effects in a recession, we must have $\Delta\alpha < 0$ (so that t falls and/or g rises in a recession when $y < 0$). But to increase the automatic stabilizers (and rainy day funds) in a boom, we must have $\Delta\alpha > 0$ when $y > 0$. In practice, these effects will come from the progressivity of the tax and benefits system; or from the nonlinear effects of subsidies and profit taxes; or from changes in the tax base around the cycle.

Lastly we assume that the monetary authorities set interest rates to eliminate inflation (and perhaps output gaps), using some form of a Taylor rule:

$$i = \lambda(\pi + \beta y) \tag{A4}$$

Now

$$y = \mu[\omega\varepsilon_d + (\phi_2 + \phi_4)\varepsilon_s], \text{ and } \pi = \mu[\varepsilon_d - \omega(1 + \alpha\phi_1 + \phi_3 + \beta\phi_2)\varepsilon_s] \tag{A5}$$

where $\mu = 1/(\omega(1 + \alpha\phi_1 + \phi_3) + \phi_2(\lambda + \beta\omega) + \phi_4)$. Hence,

$$\frac{\partial d}{\partial \alpha} = \mu^2[\omega\varepsilon_d + (\phi_2 + \phi_4)\varepsilon_s][\alpha\omega\phi_1 - (1/\mu)] > 0 \tag{A6}$$

and

$$\frac{\partial y}{\partial \alpha} = -\mu^2[\omega\varepsilon_d + (\phi_2 + \phi_4)\varepsilon_s]\omega\phi_1 > 0, \tag{A7}$$

since $\alpha\omega\phi_1 - \mu < 0$ by definition. The signs of (A6) and (A7) then follow if $\varepsilon_d/\varepsilon_s < -(\phi_2 + \phi_4)/\omega$ and $\varepsilon_s > 0$; or if the reverse inequality holds when $\varepsilon_s < 0$. Under these conditions, increasing the automatic stabilizers in a slump will lead to smaller deficits, but larger cycles. But since the two shocks can be positive or negative, the reverse can also be true. In that case, increasing the automatic stabilisers in a slump would lead to larger deficits, but smaller cycles. Thus, with stronger automatic stabilizers, we should expect either stabilized national incomes, or...

BOX 4.3 continued

...stabilised budgets – but not both. This is because (A6) and (A7) necessarily share signs.¹⁶

The lesson from this model is that the strength of the automatic stabilizers really has very little to do with the success of the SGP. Since any stabilization of the cycle will be accompanied by a destabilization of the budget (and vice versa), we can only get greater cyclical stability with a limited destabilization of the budget if the derivatives in (A6) are smaller than those at (A7). That means that $\phi_1 > 1 + \phi_3 + \beta\phi_2 + (\phi_2\lambda + \phi_4)/\omega$ must hold irrespective of the signs of the shocks. In other words, the budget multipliers must be large enough.

However, once we know whether the cycle will be increased or decreased, the amount by which $\partial y / \partial \alpha$ fluctuates more than $\partial d / \partial \alpha$ does (that is, the amount of cyclical stability we get per unit of extra budget instability) will be increased if $(\omega\varepsilon_d + (\phi_2 + \phi_4)\varepsilon_s)\mu^2$ becomes larger. For a slump, that means each $\varepsilon_d < 0$ must be matched with a sufficiently small positive excess-supply response. That would require some relative prices to fall, or layoffs, or stockpiling or reductions in investment, to reduce capacity as markets adjust to meet the new demand conditions. Similarly, in a boom period we need markets to adjust so that each positive demand shock is matched by sufficiently small negative supply response. In other words, we will only get fewer breaches of the SGP and some rainy-day funds, if markets (and labour markets in particular) are sufficiently flexible.

4.4 The limits of dead rules

The proposals reviewed above all stay within the framework of 'dead rules'. That is, they are based on the idea that sustainability can be achieved by subjecting governments to some fixed, numerical restrictions on some measure of the fiscal stance. In this section we highlight the shortcomings that this approach has in principle, and we point out the contradictions of trying to make strict rules flexible enough to accommodate the needs of optimal fiscal policies. Most of our arguments apply generally to the design of fiscal policy rules. In some instances we will refer to the specific contradictions between the goals and the mechanisms in place of the fiscal policy restrictions of the SGP, contradictions that arise from the lack of transparency of the objectives.

There are two main points of tension and contradiction.

1. Simple rules cannot be flexible

The original rules of the SGP were simple. They imposed straightforward numerical ceilings on deficits and debts and were expected to be applied automatically and without any political haggling and *ex post* bargaining over the practical implementation of the SGP. The qualifications added to the 3% and 60% limits

16 A similar conclusion arises if we wish to generate surpluses ('rainy-day funds') in good times. In that case, increasing the automatic stabilizers means $\Delta\alpha = \Delta(t - g) > 0$ and $\partial d / \partial \alpha < 0$, assuming $\varepsilon_d > 0$ is sufficiently large; and also $\partial y / \partial \alpha < 0$, where $y > 0$. These changes will require the conditions at (A7) to be reversed. So once again, increased stabilizers would typically get us either larger rainy-day funds, or a damped cycle, but not both.

contradict the very idea of a simple fiscal rule, since they open the door for discretionary interpretation and political bargaining.

Before 1998, there was also a simple and strong enforcement mechanism. A country could lose the opportunity to enter into EMU if it broke the rules of the Maastricht Treaty. The Treaty largely owes its success in the run-up to EMU to its simplicity.¹⁷ If it has failed to discipline governments afterwards, it is because, despite the clarity of the rules, it was sufficiently ambiguous to allow political interpretations of the economic numbers, as was the case with the debt figures. The current practice of the SGP and the new proposal of the Commission are both moving further in this direction by adding greater flexibility (that might be welcome for other reasons) to a simple rule that can only be credible and enforceable in the absence of such flexibility. This is a contradiction which the new proposals not only fail to solve, but actually serve to make more evident.

2. Without transparency in goals, a rule cannot be simple and consistent
Because of the evident difficulty in enforcing the rules of the SGP, the current practice of strong surveillance of the public finances of EMU members has gone well beyond the notion of avoiding sustainability problems. For example, the proposal of the European Commission suggests penalties for governments that follow pro-cyclical fiscal behaviour in good times, which has nothing to do with sustainability. Any new objectives of the SGP should be clarified and made transparent.

The rhetoric of the Commission mixes several different distortions in fiscal policy that the SGP supposedly corrects. First, excessive deficits, that is, the idea that unconstrained governments will accumulate deficits that become unsustainable. Second, excessive volatility, that is, the notion that governments use fiscal policy for political or electoral reasons, and avoid adjustment in periods around elections as long as they have a margin to do so. This is what we have seen in Germany and France around the last two elections. Third, sub-optimal policies in each economy, that is, the lack of coordination among national governments to internalize spill-overs and deal efficiently with the effects of EU-wide policies on individual economies.

The first problem is how to interpret some of these goals. For example, what does coordination mean? The (increasing) emphasis that the Commission places on the word coordination seems to be guided by the notion of creating a framework for fiscal discipline that applies equally to all EMU members. In other words, the spirit of the proposal is not so much about making sure that all countries have a similar fiscal stance or that they internalize possible externalities, but simply that fiscal policy must be run according to some common principles.¹⁸ This interpretation is very different from the standard definition of coordination used in the academic literature that stresses the internalization of spill-overs across countries or between monetary and fiscal policy.

17 See the 'Maastricht effect' in the fiscal policy response functions identified in Hughes Hallett *et al.* (2001).

18 Buti and Sapir (1998) take a similar perspective, writing: 'there is a need for coordinating budgetary policies towards sound medium-term objectives'. That is, all countries should implement good fiscal policy, which is implicitly taken to mean that they should all adopt the same type of policy.

But even if those goals were made clear and explicit, the design of a simple and effective set of numerical constraints on fiscal policy would be conditional on the relative weight that is put on each of the distortions that are being addressed. If debt sustainability was the main distortion to be corrected, setting simple numerical limits on deficits or debt levels might be enough. But if we also want to limit irresponsible fiscal behaviour (such as pro-cyclical budgets), then simple rules would not be enough.

4.5 Living bodies replacing dead rules: the role of institutions

Designing institutions that can achieve the goal of sustainability without the straitjacket of a rigid numerology is the alternative to dead rules. This is not a new idea. In fact, the reform of monetary policy in the past decades has followed this approach. The experience of the 1970s and 1980s has shown that discretionary monetary policy is subject to a severe inflation bias which arises from the conflict between the goal to achieve price stability and the desire to use monetary policy to keep output and employment high in the short run.¹⁹ One way to solve this problem is to subject monetary policy to rigid rules for interest rates or money growth. But tying the hands of monetary policy-makers in this way implies that monetary policy cannot smooth the business cycle, resulting in larger fluctuations of output, employment and inflation. The alternative solution is to delegate monetary policy to an independent central bank that has no reason to pursue ambitious, short-run goals for employment and output and concentrates on price stability and macroeconomic stabilization instead. Over the past 20 years, many countries have moved in this direction and created central banks that are credible, have clear mandates and run monetary policy based on the judgement of central bankers. EMU is no exception. The advantage of independent central banks over fixed monetary policy rules and discretionary monetary policy run by governments is no longer an issue for policy-makers or for academics.

The lesson from monetary policy raises two questions for our current context. First, do institutions matter for fiscal policy in a similar way? There is in fact growing empirical evidence that this is the case. Political and electoral systems, budgeting procedures and political constraints faced by governments have been shown to have significant effects on different dimensions of fiscal policy. The empirical studies by von Hagen (1992a), von Hagen and Harden (1994, 1995), Alesina and Perotti (1995) von Hagen et al. (2002a), Fatás and Mihov (2003), and Lane (2002) show that the design of budget processes (e.g. relative power assigned to the finance minister and the importance given to budgetary targets) and different degrees of political constraints (e.g. number of veto points in the budgetary decisions) have a significant impact on fiscal outcomes such as the budget deficit, the success of fiscal consolidations and the volatility of discretionary changes in the budget.

Second, can the logic of independent central banks be applied to fiscal policy? Von Hagen and Harden (1993), Eichengreen et al. (1999) or, more recently,

19 See Barro and Gordon (1983).

Wyplosz (2002) have proposed the creation of independent committees or boards that ensure that fiscal policy is consistent with the goals set by the political power. In these proposals, and unlike in the case of monetary policy, the board does not have an instrument (such as the interest rate) to achieve a certain goal (such as an inflation target in the case of monetary policy). Instead, the independent fiscal policy committee or board uses judgement to assess whether the budgetary goals of the governments are consistent with a predefined set of goals (i.e. a mandate) and has an enforcement mechanism to make sure that the actions of the government correspond to these goals.

From a practical point of view, the idea is less far-fetched than it might seem at a first glance. Under the Bretton Woods regime, monitoring national fiscal policies with a view towards sustainability was an important part of the IMF's role. The IMF regularly reviewed and commented on fiscal policies and made public recommendations. Since then, several countries have created institutions that resemble the idea of a fiscal policy committee or board in recent years. These committees have emerged or gained importance mostly in the context of fiscal federal relationships and the need to cope with the fiscal criteria of the European fiscal framework. The High Council of Finance in Belgium is an early example. In 1992, the Belgian Parliament gave the High Council of Finance, which had existed for a long time already, the role of monitoring the compliance of all parts of government with Belgium's convergence programme. The Council issues recommendations on borrowing requirements for the different levels of governments and writes a report on the achievement of these targets. It has played an important role in the Belgian fiscal adjustment of the 1990s (Stienlet, 1999).

In Austria, the Committee on Public Debt (*Staatsschuldenaussschuss*) was reformed in 2001. It reports to Parliament annually on the development of public debt in Austria and makes recommendations for fiscal policies. A much weaker version of such a committee is the German Financial Planning Council (*Finanzplanungsrat*), through which the federal and the state governments coordinate their fiscal policies. In 2002, the German federal government attempted to turn the Council into a framework for an internal Stability Pact, which would have given the states greater and more explicit responsibilities in meeting Germany's obligations from the SGP. The Council makes recommendations for budget developments, monitors the budget implementation and proposes corrective measures, if necessary. Since it has no sanctioning authority, however, its decisions and the agreements made within it have no binding power (Balassone et al., 2002). An important example, finally, comes from Australia. The Australian Loan Council was, for many years, a powerful mechanism to coordinate the borrowing policies of the federal government and the provinces. Specifically, it imposed annual ceilings on provincial deficits, which were negotiated as part of the budget process.

A related institutional arrangement can be found in several national budgeting processes. In these countries, the finance minister has the power to set a ceiling for the annual deficit at the outset of the process (see von Hagen et al., 2001). The difference between this practice and our proposal is in the authority setting the ceiling and the enforcement mechanism. From the discussion above, it seems that non-partisan enforcement by an independent body outside the government would improve the credibility and implementation of policies intended to reach those targets.

5 The Sustainability Council for the Euro

5.1 Introduction

So far, we have argued that:

- the stability of the common currency needs an appropriate framework for fiscal policy to maintain the sustainability of public finances;
- sustainability is a difficult concept in practice, requiring a translation of long-run constraints into short-run prescriptions for and judgements on fiscal policy;
- the assessment of sustainability requires judgement of the quality of public finances and its consequences for the short-term and long-term growth prospects of the economy;
- the rules-based approach of the SGP is not an appropriate framework to achieve sustainability.

In this chapter, we present our alternative. At the heart of the proposal is the idea to replace dead rules by expert judgement. For this purpose, we propose the creation of the Sustainability Council for the euro area. The Sustainability Council's task would be to provide an informed assessment of the fiscal situation and outlook of each EMU member state, taking into account all relevant aspects of the situation. This would bring the fiscal policy framework of EMU back to the spirit of the Maastricht Treaty and the original EDP. Importantly, however, by entrusting the analysis and judgement of sustainability to an independent council, it would solve the basic credibility problem of the SGP, that is, that the governments through ECOFIN judge the quality of their own policies. In our proposal, the proper link between the EMU's long-run interest in sustainability and short-run constraints and exigencies on fiscal policy is preserved by the independence from short-term political pressures of the body making the assessment. In this chapter, we discuss the main requirements to make our proposal work.¹

The Sustainability Council would be created by and report to the European Parliament, which would also provide its resources. Its members should be experts on public finance and public finance management of high professional standing. Membership in the Sustainability Council need not be a full-time

1 Our proposal builds on work originally presented in von Hagen and Harden (1994), further elaborated in Eichengreen, Hausmann, and von Hagen (1999). A related proposal drawing on these ideas was recently presented by Wyplosz (2002).

activity for all members, although the chairperson and the vice-chairperson of the council should have full-time professional appointments. The Sustainability Council should have a small staff and secretariat and should have guaranteed access to all relevant information at the national and the EU level. The Sustainability Council should have the right to use the services of the European Commission and of the national government accounting courts to support its work.

The idea of creating yet another institution at the European level may seem unattractive to some. After all, the current European structure, with its network of overlapping policy processes and its institutional set-up, which is already utterly untransparent for the public, seems to call for fewer rather than more institutions and policy-making bodies. Others may find the idea of delegating some authority over public finances – historically the core of parliamentary rights – to an independent council as incompatible with modern democracy. These criticisms must be taken seriously. In our view, however, the Sustainability Council would improve transparency and the functioning of democracy (von Hagen and Harden, 1994). The delimitation of the Sustainability Council's authorities and competencies is the key issue here. As indicated above, several EU countries have already moved in this direction in recent years.

5.2 A clear mandate: safeguarding sustainability

The Sustainability Council would have the sole statutory task of safeguarding the sustainability of public finances in the member states of EMU. This mandate follows the principle of subsidiarity by confining the Sustainability Council's activities to the principal common concern of monetary stability in EMU. It is the counterpart of the principal task assigned to the ESCB² of maintaining price stability. In contrast to the ESCB, however, the Sustainability Council would have no need of a secondary objective such as supporting the general economic policies in the euro area. The reason is that the Sustainability Council would have no *operative* role in fiscal policy, such as setting taxes or public expenditures. The use of all instruments of fiscal policy would be left to the national governments. Within the economic framework of EMU, the function of the Sustainability Council would be to make the implications of the governments' intertemporal budget constraint explicit. To fulfil its task, the Sustainability Council would have to assess the financial position of a government in all relevant aspects, to produce forecasts of future financial developments and, on this basis, to evaluate the risk of future fiscal crises.

As discussed above, the empirical content of the sustainability of public finances, like that of price stability, is rather vague, and it varies with economic circumstances over time and across countries. An important part of the Sustainability Council's task would, therefore, be to develop a framework for the assessment of public finances and for making forecasts and judgements. This,

2 The ESCB comprises the ECB and the national central banks of all EU member states. In contrast to the ESCB as a whole, the ECB has been vested with legal personality by the Treaty. The national central banks have legal personality as provided by the respective national laws.

again, is similar to the task of the ECB, which had to develop its own, operational definition of price stability. But the Sustainability Council would probably not settle on a unique number in this definition as the ECB did for price stability. In fact, there is no need to do that, since, in contrast to the ECB, the Sustainability Council would not be charged with implementing the policies it recommends. Since there would be no need to hold the Sustainability Council accountable for its actions in the short run, its definition of sustainability would not have to be as precise as a central bank's inflation target. Thus, the Sustainability Council would be free to develop an empirical concept of sustainability that overcomes the basic problem, that is, that general numerical limits are not meaningful in this context.

An important question is whether the mandate of the Sustainability Council would be to safeguard the sustainability of aggregate public finances in EMU, or the sustainability of public finances in the member states of EMU. The latter mandate, which corresponds to the current obligation of the national governments to maintain the sustainability of their public finances, would focus on the fiscal situation and outlook of each individual country. Its basic tenet is that the stability of the euro is guaranteed when sustainability of public finances prevails in each and every member state. This is obviously more stringent than necessary. In principle, the stability of the euro could be preserved even in the face of a massive and lasting public debt expansion in an individual member state, provided that other member states are willing to make the necessary adjustments, including the readiness to assume financial liabilities of that state. But it is clear that considering this possibility poses major difficulties for the Sustainability Council. Since the Council itself would not have the political power to forge such an arrangement among the member states, it would have to rely on voluntary commitments and promises of the member states. Under the current Treaty, however, such promises are not credible in view of the no-bailout clause or Art. 104. This very clause, therefore, suggests that the Sustainability Council should have the explicit mandate to safeguard the sustainability of public finances in every member state of EMU. Anticipating that the EU, at some point in the future, might have greater fiscal powers itself and that, therefore, profligate fiscal policies at the EU level might endanger the stability of the common currency, the mandate should be broad and include the sustainability of public finances of the EU.

The fact that the Sustainability Council would not have the authority to set fiscal policy instruments is also key for the democratic legitimacy of the arrangement. As indicated above, the right to determine the level and distribution of taxes and spending is at the heart of parliamentary democracy. In this context, the Sustainability Council's mandate is to make the limits that EMU imposes on national fiscal policy choices explicit. This is a legitimate interest of the union, and it can be assumed that national parliaments and governments, by agreeing to enter into EMU, agreed to accept those limits. Thus, the creation of a Sustainability Council does not take away further sovereignty from national governments compared with what is implied already by entering EMU.

Nevertheless, the Sustainability Council could hardly make a judgement on the sustainability of a country's public finances without forming a view of the proper size and structure of its public sector. The Council's assessment of a country's fiscal situation and outlook may, therefore, contain comments and recommendations regarding the total volume and distribution of public spend-

ing and revenues. Such comments and recommendations could easily lead to a disagreement between the Sustainability Council and a national government, if the latter desires an increase in the overall size of the public sector or a change in its structure. Governments could help avoid such conflicts by announcing multi-annual targets for the size and structure of the public sector. This would also ensure that the Sustainability Council's decisions were linked to democratic political choices and have the additional benefit of improving the democratic accountability of governments in public finances.

5.3 Method of operation: the assessment process

The Sustainability Council can be conceived as a referee for the budgeting processes of EMU member states. The national governments would have to submit their annual and medium-term fiscal plans to the Sustainability Council in the early phase of their budgeting processes, usually in March or April of the year preceding the budget year under consideration. The Sustainability Council would judge the compatibility of the change in general government debt implied by these plans with the sustainability of the country's public finances. Its judgement would take into account the past and current economic performance and the medium-term outlook of the country under consideration as well as the past fiscal performance of its public sector. The Sustainability Council would veto a government's fiscal plans if it came to the conclusion that they were not compatible with sustainability. In this case, it would demand adjustments from a national government and it could make proposals for such adjustments. The Sustainability Council would deliver its vetoes in public within two months after the submission of the national fiscal plans to ensure that the government could adjust its budget in time. The Sustainability Council would then make a public assessment of the adjustments proposed by the government.

In those cases where the Sustainability Council did not veto the national fiscal plans, it could deliver its report at a later time, but no later than October. With this deadline national parliaments would be informed of the Sustainability Council's assessment when they vote on the annual budgets of their governments.

During the course of the fiscal year, the Sustainability Council would monitor the development of public debt in the member states, to see whether governments comply with their plans and whether any unforeseen developments occur that might have negative consequences for sustainability. The Sustainability Council would comment on such situations in public and admonish governments that deviate substantially from their fiscal plans, especially if the sustainability of their public finances were at risk.

There is a substantial difference between the change in general government debt, the main focus of the Sustainability Council's assessment, and the reference values for annual deficit and debt ratios of the Maastricht Treaty. The difference is in the definition of the deficit. The Treaty defines a deficit on an accruals basis, implying that some items are excluded that the Sustainability Council would cover in its limit, such as privatization receipts, capital ('below-the-line') transactions, or changes in the value of foreign-currency denominated debt. The constraint created by the Sustainability Council would, therefore, be more encompassing. Similarly, the Sustainability Council would take a more

comprehensive view of public debt in its annual assessment of sustainability, including, for example, pension liabilities or hidden guarantees of the public sector.

The Sustainability Council's judgement would thus create an unambiguous constraint on general government borrowing of all forms. Any increase in debt exceeding the limit set by the Sustainability Council would be considered incompatible with sustainability and, therefore, a violation of the obligations of the Maastricht Treaty. There would be neither room nor a need for further judgement, because all relevant judgement would already have been incorporated in the pronouncement of the Sustainability Council. The existence of the Council would, therefore, eliminate all political haggling over deficits and debt.

The statutes of the Sustainability Council would provide that its decisions are final. They could not be changed by the European Parliament, by a national parliament, by the national governments, by other Community bodies or by the Sustainability Council itself. The only exception to this rule would be the case of a natural or other disaster.

To fulfil its task, the Sustainability Council would produce annual reports on the sustainability of public finances in each member state. Obviously, this could be a very short one, if the Council sees no problems for an individual member state. Without prejudice to its independence, the Sustainability Council would and should allow for participation of the national governments and other institutions such as the ECB in the process, for example, by holding hearings with experts and representatives of the relevant bodies. The Sustainability Council should use all relevant information for its tasks and be able to obtain that information.

The Sustainability Council could have procedures allowing for different degrees of intensity of its involvement for different countries. For example, the Sustainability Council could apply a simple first test using some rather broad-brushed analysis and turn to a more intensive investigation only in cases where the first test is failed. The 3% and 60% criteria of the EDP are examples for such a first test. This would likely reduce the number of countries investigated intensively each year and, therefore, allow for leaner resources of a Sustainability Council overseeing the sustainability of public finances in an EMU of, say, 20 member states.

To involve the national public in the process as much as possible and to avoid the impression that the government and the country were judged by an institution far removed from its economic and political particularities, the Sustainability Council would deliver its report and especially its veto on a member state's fiscal plans in the capital city of that member state. Bringing the Council's judgement into the individual countries could enhance the political ownership and public support of the process.

5.4 Credible enforcement

Under the European Treaty, member states of EMU have the unconditional obligation to safeguard the sustainability of public finances. If the Sustainability Council has the mandate of defining and operationalizing what sustainability means and implies for national fiscal policies in the short run, this obligation implies that national governments are committed to implementing the

Sustainability Council's judgements and prescriptions. The question remains, how this commitment can be effectively enforced. The current framework of public finances in EMU relies on two enforcement mechanisms, peer pressure and the possibility to impose financial fines on countries with persistent excessive deficits.

But the effectiveness of these enforcement mechanisms remains very much in doubt. As shown in Chapter 1 of this Report, the experience with fiscal policies in the 1990s suggests that peer pressure works in the small EMU states. In the large states, Germany, France and Italy in particular, the wish to be a 'good European' seems to have much less influence on national policy choices and, indeed, national elections. The effectiveness of the threat of financial fines remains to be tested in the EMU framework. But the lenience with which Germany's and France's fiscal developments were treated in 2002 and 2003 suggests that the European Commission and the Council wish to avoid that test.

It is clear that the Sustainability Council could rely neither on peer pressure nor on financial fines. Being a Community institution, the Sustainability Council is different from the governments; it does not talk to them as a council of government representatives like ECOFIN does. At the same time, the Sustainability Council could not impose penalties on national governments, because its role is different from the role of the Community's European Court of Justice. It is conceivable to create a Sustainability Court in addition, where states could be challenged for violating the obligation of sustainable public finances, and which would impose penalties on states where this is true. But court judgements would always come much after the fact, and the judicial process would not be able to achieve timely corrections to policies deemed non-sustainable. The Sustainability Council, in contrast, should work in a much more forward-looking way, signalling risks of fiscal crises before crisis hits and demanding policy adjustments that prevent crises. Thus, in contrast to a court that judges what governments have done, the Sustainability Council would also judge what governments intend to do and what this means for the future course of fiscal policy. Furthermore, since the concept of sustainability is sufficiently vague empirically, the same government policies may or may not be compatible with it under different, specific circumstances. Thus, in contrast to a court that interprets what the law means for all member states, the Sustainability Council would have to make judgements that are very specific to individual circumstances.

In view of this, the only enforcement mechanism the Sustainability Council could credibly rely on to enforce its judgements and prescriptions would be its ability to generate political pressures through public opinion and financial market reactions. To facilitate this, the Sustainability Council should have the right to make its judgements and recommendations fully public in a timely manner. It should have the right to make differentiated judgements on the fiscal situation of each member state in public, pointing to risks and problems as it sees fit. It should also have the right to educate public opinion through public statements about the importance, the proper interpretation and the implementation of sustainability. The Sustainability Council should be allowed to talk to the European Parliament and to national parliaments. Finally, in order to create clear competencies and avoid political haggling, the Sustainability Council should have the sole right to propose the imposition of the financial fines under the EDP to the ECOFIN Council. Threatening financial fines would be its most

powerful instrument to raise public awareness in a country. To make the process most effective, the ECOFIN Council should be required to reject the Sustainability Council's proposal to impose financial fines by a qualified majority.

Enforcement in this way can only work if the public regards the Sustainability Council as an authority on this matter. The need to rely on public opinion, therefore, creates a strong incentive for the Sustainability Council to exert the best possible judgement, make its decisions transparent and use its public role most carefully. A Council making unreasonable proposals or posing unreasonable demands would soon lose attention in the public debate, as would a Council basing its judgements on shaky analysis and questionable assumptions. Thus, the limitation of the enforcement power would at the same time be the best guarantee for a high-quality performance of the Sustainability Council.

An important criticism of this proposal is that public announcements, by shaping financial market expectations, can precipitate fiscal crises in situations where a crisis could have been avoided otherwise. The analogy comes from the economics of currency and banking crises. Multiple equilibria can arise in government debt markets, when debtors are willing to hold the debt of a government, if they remain convinced that future adjustments of fiscal policies will restore the solvency of the government, but sell the debt when they expect that such adjustments will not happen or will not suffice. In such a situation, the Sustainability Council's public announcement that the sustainability of the country's debt is in doubt could shift market expectations from the first to the second scenario and result in massive sales. In view of this possibility, one might argue that the Sustainability Council should not be allowed to make public announcements regarding the possibility of fiscal crises, to avoid such cases of self-fulfilling expectations.

We do not agree with that criticism. Given the institutional set-up of EMU, the influence on market expectations and public opinion is the only powerful instrument the Sustainability Council would have to discipline governments pursuing non-sustainable policies. These instruments should work also in the large countries and they are, therefore, of critical importance for the Sustainability Council to be effective. Furthermore, the Sustainability Council will only be able to influence market expectations, if market actors regard it as competent in the relevant matters. This implies that the Sustainability Council will have a strong incentive not to abuse its right to make public announcements and refrain from hints at impending fiscal crises unless the situation is truly severe. At the same time, governments in EMU should have an opportunity to prepare a response in reasonable time and not be taken completely by surprise by announcements of the Sustainability Council. This can be achieved by demanding that the Sustainability Council forwards its assessment of a country to the relevant government a few days before it is made public.

5.5 Independence, accountability and transparency

To fulfil its role properly and make unbiased judgements, the Sustainability Council would have to enjoy full political independence of the national governments of the member states and of other EU institutions. Like the independence of the ECB, the independence of the Sustainability Council would be

determined in five statutory rules.

First, a rule stating that the Sustainability Council does not take any directives from any national government of EU member states, from other national institutions of EU member states, or from any Community institution.

Second, a rule stating that the Sustainability Council has the right to develop its own framework of analysis and its own operational concept of sustainability.

Third, a rule determining the resources available to the Sustainability Council. This rule should fix the Sustainability Council's budget for a medium-term horizon of, say, five years, and should be amendable only by a qualified majority of the votes in the European Parliament. Such a rule would shield the Sustainability Council from any attempt of myopic politicians to make it ineffective by draining it of resources. The remuneration of Sustainability Council members should be determined by the Council's statutes and linked to the salaries of comparable EU offices. Governments of the EMU member states and the European Commission should be required to give the Sustainability Council full and timely access to all information requested.

Fourth, the members of the Sustainability Council should be personally independent from political pressures. Following the ECB example, personal independence could be assured by giving the Sustainability Council members fixed-term, non-renewable appointments. Their appointments should be long enough to allow them to acquire the necessary expertise and standing in the public debate. Appointments should be staggered to assure that the Sustainability Council does not change entirely at the end of a given year, thus assuring continuity in its views and judgements. It should be impossible to dismiss members of the Sustainability Council except for severe faults of unethical or unprofessional behaviour, to ensure that they cannot be threatened to be removed from their positions if they make decisions which are unpopular with the governments. Members leaving the Sustainability Council after the expiration of their term should be kept from taking national political offices for a period of between three and four years to assure that they have no incentive to pay favours to national governments in order to secure their post-Council career perspectives.

Fifth, the Sustainability Council's freedom from political pressure should be balanced by appropriate mechanisms of accountability to assure its effectiveness and democratic legitimacy. For this purpose, the Sustainability Council should report to the European Parliament regularly. The European Parliament should have the right to call the chairperson of the Sustainability Council for public hearings and it should have the right to dismiss the Sustainability Council *in toto*. This last provision, however, should be limited by two specifications. First, that the Sustainability Council may be dismissed only by qualified majority of the European Parliament, and, second, that the last pronouncement of the Sustainability Council would not be out of effect when the Council is dismissed. In this way, the European Parliament would be kept from abusing its power for the sake of short-sighted political gains, and it could dismiss the Sustainability Council only in cases where a broad majority felt that it did not perform properly. Given the large publicity that such an action would have, the European Parliament would do that only in cases of severe misperformance of the Sustainability Council.

The independence of the Sustainability Council also demands a high degree

of transparency of its operation. Limited transparency would only reduce the effectiveness of the Sustainability Council's public announcements, as the public might doubt the Council's competence and lack of bias. This calls for the publication of all materials relevant to the Council's judgements and decisions, including a clear exposition of the criteria used for the assessment, as well as the minutes of Sustainability Council meetings. There is no need to publish these materials immediately after a meeting or decision. Such a requirement might affect the Sustainability Council's ability to obtain and process all relevant information. Instead, the Sustainability Council could choose a publication lag of several months, within which all relevant information is published.

Apart from that, all members of the Sustainability Council should be free to express their views on the sustainability of public finances of individual countries in public. This would promote an open debate about the relevant issues in member states where sustainability is indeed at risk, and, therefore, raise public pressures on the governments to correct the situation.

5.6 Composition and appointment procedure

We have argued above that, in contrast to the optimality of public finances, which is a political concept involving preferences over the level and composition of public spending and taxation, sustainability is a technical constraint on public finances. This implies that the Sustainability Council's task is essentially a technical one, even if the Council would play an important role in the political process. Given the technical nature of its mandate, members of the Sustainability Council should have sufficient economic expertise and experience with the practical management of public finances. In some member states of the EU, academics with the necessary expertise would probably be regarded as appropriate members of the Sustainability Council, while in other member states, such candidates would count as irrelevant and the public would prefer individuals with careers in international institutions such as the IMF. Since the appointment of the members would be by the European Parliament, the members of parliament could take care of such national differences in preferences through the nomination procedure.

For a European institution, the question of national representation also arises. Here, again, it is important to recognize the technical nature of the Sustainability Council's mandate. Since the Sustainability Council does not have to make political judgements concerning the optimality of a country's public finances, it would not be essential that all EMU member states be represented on the Council. This means that the size of the Sustainability Council can be limited to less than ten members, ensuring that the Council's work and meetings are manageable.

Members of the Sustainability Council should be appointed to their offices by the European Parliament. The appointment process should be open and transparent and be managed by the chair of the Economic Affairs Committee of the European Parliament. Candidates should be proposed to the European Parliament by the committee after hearings with them and after the committee has received an opinion from ECOFIN.

5.7 Institutional alternatives

Our proposal envisages the Sustainability Council as a referee of the budgetary plans of EU member states. This can be considered the minimum authority required for the implementation of a judgemental approach in the European context. Compromising on the design of an independent, accountable and transparent Sustainability Council would obviously have negative repercussions on its proper operation. There are, however, institutional alternatives, which we will briefly outline in the following sections. One could create a more powerful institution, either at the European or the national level, endowing the Sustainability Council with stronger agenda-setting power and enforcement mechanisms. This would strengthen the capacity of the Sustainability Council to safeguard sustainability. However, governments would have to relinquish more of their discretionary authority over fiscal policies. Whether EU member states want to take such a far-reaching step therefore ultimately depends on the degree or structure of policy coordination they envisage for the future.

5.7.1 The Sustainability Council as an agenda setter

Instead of mainly being a referee of budgetary plans, the Sustainability Council could become an agenda setter in this process, spelling out annual limits for the increase in a member state's general government debt at the beginning of the budgeting process.³ The national governments would then be obliged to observe these limits, though of course, they would be free to choose an increase in general government debt smaller than the limit set by the Sustainability Council.

The role of an agenda setter would increase the public visibility of the Sustainability Council in each member state, but also the intensity of its involvement with national public finances. The Sustainability Council would have to have a more intensive investigation into a country's economic and fiscal situation and outlook every year to do a good job. With 20 or more member states in the EMU, this could easily become a very large task demanding substantial resources for the analysis and a lot of time for hearings and consultations. The Sustainability Council could then easily become a fairly large administration itself.

Importantly, making the Sustainability Council an agenda setter in the national budget processes would shift the burden of proof regarding sustainability from the national governments to the Sustainability Council. If the Sustainability Council sets annual limits for the change in general government debt, national governments and the public could assume that countries meet the sustainability requirement as long as they observe the annual limits set by the Sustainability Council. In principle, the national governments themselves would not have to worry about sustainability any more and simply rely on the judgement of the Sustainability Council instead. The Sustainability Council would then find it hard to demand fiscal adjustments from a national government, if that government observed the limits set by the Council before, even if, due to some new information, the Council had to change its view on the situation. The Sustainability Council would thus assume responsibility for sustainability in the eyes of the policy-makers and the public.

3 See von Hagen and Harden (1994) and Wyplosz (2002) for discussions of this model.

In contrast, this responsibility would remain with the national governments if the Sustainability Council were perceived as a veto player. The burden of proof would remain with the national governments who would have to convince the Sustainability Council that their policies and plans were sustainable given the current economic situation and the outlook for the future. This would force the governments to argue openly about sustainability and signal that sustainability is their responsibility. Since the governments retain full control over all fiscal policy instruments and, therefore, control all possible adjustments to be made when sustainability is at risk, it is clear that being a veto player is a more appropriate role for the Sustainability Council.

The appropriate composition of the Sustainability Council would also be affected if the Council were designed as an agenda setter. The more the Sustainability Council would assume responsibility for sustainability, the more political its role would be, political in the sense of interfering with current debates about public finances in the member states. This indicates that the members of the Sustainability Council should bring some public policy experience to their offices in addition to the required expertise in public finance. Furthermore, national representation would become a more pressing issue, if the Sustainability Council acted as an agenda-setting body and had a more active political involvement. For the public in the individual member states, the assurance of being properly represented on the Sustainability Council by a person understanding the situation of their country would be important for the legitimacy of the institution. These considerations suggest that a Sustainability Council designed to be an agenda setter in the budgeting processes of the member states would be a larger institution and more difficult to manage than a Sustainability Council whose principal role would be to deliver public assessments of the sustainability of public finances.

5.7.2 National Sustainability Councils

The implementation of Sustainability Councils at the national level of the EMU member states would be another alternative to our proposal. It would correspond closely to the proposal of National Debt Boards presented in von Hagen and Harden (1993) and Eichengreen, Hausmann and von Hagen (1999). At the national level, these councils would be created by and report to the national parliaments. An important advantage of this alternative is that the national councils could be vested with more powerful and more formal enforcement powers. For example, Harden and von Hagen (1993) propose that the national councils should have the right to impose across-the-board spending cuts on all levels of government, if the annual limit on the change of public debt were breached. The implementation of such councils would fulfil the obligation of all EMU member states according to Art. 3 of the Protocol on the Excessive Deficit Procedure, that is, that the member states implement procedures at the national level, enabling them to maintain sustainable public finances.

This alternative would have the further advantage that the national Sustainability Council could be even more effective in working with public opinion and that their democratic legitimacy would not be an issue, since they would be created by national law. National Councils would be naturally in a better position to judge their countries' fiscal policies, since the Council members would be more familiar with national habits, attitudes and circumstances.

The main disadvantage would be that these Councils would reflect the common interest of the monetary union in sustainable public finances only indirectly. As a group, the member states of EMU might feel that some oversight mechanism monitoring the performance of the national Sustainability Councils were necessary to ensure that the common interest in the stability of the common currency is properly preserved. In the end, the advantages of more effective enforcement and greater visibility at the national level could be bought at the price of a more complicated mechanism coordinating and monitoring the national Councils at the European level.

6 Conclusions

The stability of the common currency needs an appropriate framework for fiscal policy to maintain the sustainability of public finances. At the heart of the current political debates over the fiscal framework of EMU is the difficulty of translating this long-run requirement of sustainability into something that is meaningful for day-to-day fiscal policies. As we have indicated in our report, there are theoretical, empirical and operational reasons why this problem cannot be solved by a simple fiscal rule focusing strictly on numerical values. Theoretically, strict compliance with a numerical rule may force governments to run policies that would not maximize the welfare of their citizens. Empirically, the quality of public finances and the structure of public consolidation efforts have important implications for short-term and longer-term economic growth. These aspects, however, cannot be captured by straight numerical targets. Operationally, the design of numerical rules faces a trade-off between simplicity and enforceability, on the one hand, and the flexibility of implementation to cover variegating economic conditions and effects, on the other hand.

We have therefore argued that the implementation of the Stability and Growth Pact requires a judgemental approach. Replacing 'dead rules' by the informed judgement of 'living bodies' could achieve the translation into short-run prescriptions, sensibly taking into account current and future economic conditions. We have spelled out the design of a Sustainability Council to implement this approach through its independent assessment of a country's fiscal plans and a credible enforcement mechanism.

How does all that figure into the current debate, and does the Sustainability Council provide a solution to the problems of the implementation of the European fiscal framework? As we have shown in our report, the preventative arm of the SGP has failed and the fate of the corrective mechanisms is highly uncertain. The dominant mood in the current policy debate seems to be asking for some relaxation of the SGP without changing it explicitly. Putting forward a more lenient interpretation, however, could be the starting point for the further erosion of European fiscal rules. To some extent, this even seems inevitable, since the current proposals do not solve the basic problems associated with numerical rules or the credibility problem related to a partisan surveillance process. If this path were taken, one can expect that the discussion about the SGP and the risk of an implementation process undermining its credibility will stay with us.

The creation of the Sustainability Council promises a way out of this dilemma. It would greatly improve the political process of public finances in EMU.

Specifically, it would allow for greater flexibility in the use of fiscal policy instruments, as the Sustainability Council would not focus narrowly on numerical criteria and would be able to use and apply good economic judgement instead. But, importantly, this increase in flexibility would not come at the cost of lower credibility, since the members of the Sustainability Council would have no need to take short-term, electoral concerns into consideration when they judge public finances. The review process of the Sustainability Council would change the public awareness of the problem by being more transparent and more focused on the critical issues connected to sustainability. Like price stability, sustainability is a difficult concept that needs continuous education of the public to build democratic support. The Sustainability Council would be in a good position to deliver that, because sustainability would be its sole task.

The Sustainability Council is actually much in line with the original intention of the Maastricht Treaty, although the latter did not envisage explicitly such an institution. Hence, one obvious question relates to the status of the Sustainability Council within the existing or future EDP and the SGP. On the one hand, one might argue that a Sustainability Council could simply be added to the current framework, leaving the substance of the current provisions essentially unchanged, although the procedural provisions would have to change.

On the other hand, the coexistence of the Sustainability Council with the current framework could pose some difficulties. The fact that the Maastricht criteria and the assessment of the Sustainability Council do not necessarily coincide implies the possibility of a conflict between a strict compliance with the rulings of the Sustainability Council and the rules of the EDP. Such conflicts could be avoided if the Sustainability Council made its judgements and recommendations with a view to the Maastricht criteria. After all, there is a fundamental coincidence of interest between the two, as both aim at safeguarding the sustainability of public finances. As noted in Chapter 1, the numerical criteria of the EDP do not define an excessive deficit, they merely serve to trigger an assessment process in which other relevant information must be used. It is, therefore, conceivable that the judgement that must be applied in the EDP is transferred to the Sustainability Council.

More importantly, however, situations could arise in which the Sustainability Council declares that the sustainability of a member country's public finances is at risk, while the European Commission and ECOFIN, the decision-making bodies under the EDP and the SGP, declare the opposite. The political haggling arising in such situations would undermine the authority of all institutions involved and leave EMU with less protection against fiscal profligacy. To avoid that risk, the provisions of the EDP and the SGP should be amended to clarify the authority of the Sustainability Council in the ways proposed above.

Some readers may find our proposal unrealistic for EMU as it is today. Even so, we think that it is of practical value. The Sustainability Council is clearly designed along guiding principles which set a benchmark for reform of the current fiscal framework of EMU. Whatever steps are taken in the future should focus on the real issue, sustainability, and aim at providing the basis for an independent assessment of public finances in a transparent and accountable manner. A practical suggestion at this point could be a strengthening of the European Commission's role within the current set-up, giving it the right to publish its own assessments, to initiate an EDP or to require ECOFIN Council to vote on a Commission proposal to open an EDP, and the right to publicly pro-

pose the imposition of financial fines to ECOFIN. The report¹ recently released by a study group established by President Prodi took on board some suggestions in this direction. This would put the Commission in the place we foresee for the Sustainability Council, if the latter takes the role of a veto player or referee. But the European Commission, an institution charged with many tasks and in need of the cooperation of national governments to achieve them, obviously does not have the same degree of political independence that the Sustainability Council with its sole focus on sustainability would have. Giving the European Commission greater authority in the current framework could hence be a step in the right direction, but it would not achieve the full goal.

1 The report, 'An Agenda for a Growing Europe', of the independent study group chaired by André Sapir, was issued in July 2003.

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