

# ■ The peaks and troughs of the Stability and Growth Pact

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*The stability and growth pact is an intrinsic part of the EMU set-up and has now been in place for five years starting in 1999. The operation of the EU budgetary framework has developed with experience, but the last few years have been turbulent. Member state budget deficits have deteriorated and approached or even exceeded the agreed limits. The debate on the performance and design of the framework has become increasingly lively, with plentiful inputs from academics and policy makers. Additional fuel was provided recently as tensions within the framework reached a new peak when the Ecofin Council decided not to continue up the Pact's decision ladder and take France and Germany one step closer to sanctions. The Council decided instead to "freeze" the formal procedure and make an intergovernmental agreement outside the regular framework. Besides heightening tensions, this outcome raised questions about the status of the framework.*

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## Introduction

The aim of this article is to outline the phases of the Pact and the Maastricht budgetary rules so far, present some of the main issues and arguments in the debate on the Pact and indicate some areas that are likely to appear in a discussion on the future of the framework.

The first section recalls the basic arguments for introducing budgetary co-ordination at EU level. The following section overviews the current rules. This is followed by a description of the main economic developments and the procedural steps within the budgetary framework since the start. After that I look at the performance of the Pact with reference to the design of the numerical rules, assessment tools and implementation mechanisms in order to see what has worked well and where problems have been greater. On this basis, the concluding section points to some priorities for a debate on reform.

## The need for EU budgetary rules

**The ambition behind the EMU framework is to promote a stability oriented macro-economic environment.**

**A specific feature of the EMU set-up is that monetary policy is centralised while fiscal policy remains decentralised.**

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The ambition behind the overall EMU framework is to promote a stability oriented macro-economic environment characterised by low and stable inflation and sound budgetary positions. Stable macro-economic conditions reduce risk and uncertainty and facilitate planning by economic agents and are thus helpful for economic growth.

A specific feature of the EMU set-up is that monetary policy is centralised while fiscal policy remains decentralised. The independent central bank, the ECB, has the authority to ensure stable prices in the euro area, while fiscal policy is the responsibility of the individual member states. The set up increase the demands on stringency and flexibility on national fiscal policy. The achievement of stable and sound budgetary positions in member states and in the area as a whole is a valuable common good and is important for conducting an efficient common monetary policy. Experience shows that unsustainable public finances tend to trigger periods of high inflation. Indeed, a key criteria<sup>1</sup> for EMU participation are sufficiently low deficit and debt levels. At the same time, the common monetary policy may not be able to react to country specific shocks. Thus, national fiscal policy needs to be flexible enough to meet the increased responsibility for national stabilisation policy.<sup>2</sup>

According to the "subsidiarity principle", co-ordination at EU level should take place only when a certain target can not be met through national policy. While fiscal policy remains the responsibility of member states, there are arguments that favour a framework of common fiscal rules at EU level. Equal treatment requires that rules apply equitably to all member states, regardless of economic weight. For this reason, it is in the interest of all members to have a common framework that ensures that other members behave appropriately and that the risk of unbalanced situations is minimised. Overall, the arguments for a centralised framework stem either from concerns to internalize cross-country spillovers or from the protection of national interests (Beetsma (2001) and Buti & Giudice (2002)).

Spillovers in EMU may materialise either directly between fiscal authorities or indirectly through an impact on the common monetary policy. Direct spillovers occur when unduly expansionary/contractionary

<sup>1</sup> A necessary condition for EMU membership is that four economic convergence criteria are fulfilled (Treaty article 121). The criteria, which relate to inflation, sustainability of the government financial position, exchange rate stability and long-term interest rates, are detailed in a Treaty protocol. The criterion for the sustainability of the government financial position is that the member state does not have an "excessive deficit" in the EDP (Article 104, see section 2 for a description of the rules).

<sup>2</sup> The increased role of national fiscal stabilisation policy in a monetary union was a key issue in the debate ahead of the Swedish EMU referendum 2002. The second government EMU report especially focused on this issue (see SOU 2002:16 and the Riksbank statement on the report).

budget positions feed into demand and trade flows. Such spillovers are not EMU specific but in a currency area they may be augmented because there is no bilateral exchange rate that can move to balance the situation. Also, an unbalanced budgetary position in one country may increase the cost of borrowing in that country, which in turn may affect the cost of borrowing in the whole area.

However, the more fundamental arguments relate to the channels through which the common monetary policy operates. First, sustainable public finances are important for the functional independence of the ECB. As mentioned above, experience suggests that budgetary positions which are not sustainable in the long-term have often been solved by printing money and creating inflation. In the EU, however, central banks or other EU-governments are not allowed to bail out a government in crisis by buying government bonds, either directly or indirectly on the secondary market ("no bail-out clause", Treaty article 101). Even so, in the event of unsustainable levels of public debt, central banks may face pressure to arrange a bail-out through other channels, either ex-ante by abstaining from raising interest rates despite inflationary tensions or ex-post by allowing inflation to deflate real debt (Buti et al. (2003)).

In addition, in EMU, national budgetary authorities may be more tempted to embark on unduly expansionary budget policies than they would be with a national currency. This is because the costs involved, in terms of adverse effects on interest and exchange rate markets, are reduced by the impact being spread all over the area. Thus, the financial markets are less able to act as a watchdog on individual members. If one member state "behaves badly" the euro area impact may be marginal but if a group of countries move in the same direction the impact could be larger.

Also, in a close political co-operation like the EU, there are "political spillovers". Turbulence in one country due to large fiscal imbalances automatically becomes the problem for everyone in that it will dominate the policy agenda and crowd out other issues.

The need for common principles is also motivated from national interest. When the Maastricht process was initiated in the early 1990s, almost every country had unbalanced budgetary positions with large deficits and high debt levels. Three "classical fiscal policy failures" can be held responsible for the situation (European Commission, 2000). First, high structural budget deficits led to constantly rising public debt levels. Second, the continuous increase in expenditure ratios led to a similar increase in tax ratios, especially on labour, with negative effects on employment. Third, fiscal policy was often pro-cyclical, expansionary in good times and restrictive in bad, thus exacerbating instead of smoothing

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swings in GDP. Against this background, some external constraints in the form of fiscal rules can help to adapt the behaviour of budgetary authorities and restore the room to manoeuvre also for fiscal stabilisation policy.

The need for sound budgetary positions and reduced debt levels is even more pronounced in view of the budgetary costs from ageing populations. Recent calculations (EPC (2003)) indicate that, if no corrective action is taken, annual costs related to ageing (i.e. pensions, health care and long-term care) will increase by 3 to 7% of GDP by 2050. The increase in costs will be evident already by 2010 and will peak between 2010 and 2030. If this development proceeds unchecked, without efficient pension system reforms and higher labour market participation, there is a risk that budgetary positions will not be sustainable with negative implications for the prospects of safeguarding low and stable inflation. Thus, it is helpful to have external constraints that strengthen the incentives to tackle this challenge at an early stage while there is still time to act.

## A brief overview of the rules and how they developed

A rule-based framework for promoting budgetary discipline may build either on procedural rules for budget execution or on numerical constraints. Given the differences across countries, the more straightforward solution in the EU is common numerical rules. The issue then is how the long-term concerns about sustainability and good fiscal behaviour are to be translated into numerical rules that appropriately guide fiscal policy. As the key instrument for guiding fiscal policy is the annual budget, an annual budget deficit constraint coupled with a debt target was chosen (see below for a discussion of the qualities of the EU numerical rules).

Two criteria were adopted for identifying an excessive deficit: the government budget balance must not be above 3% of GDP and the gross debt:GDP ratio should not be above 60%.

The EMU framework was set up in the Maastricht Treaty that came into force in 1993. Article 104 outlines the "Excessive Deficit Procedure" (EDP). The EDP requires member states to avoid "excessive deficits". As mentioned above, not being in an "excessive deficit" position is a necessary condition for EMU membership. Two criteria were adopted for identifying an excessive deficit. First, the general government budget deficit should not exceed 3% of GDP. However, a deficit above 3% may be allowed in case the overrun is "exceptional and temporary" and the deficit remains close to 3%. Second, the general government gross debt ratio to GDP should not be above 60% of GDP but, if it is, it must be on a decreasing trend at a "satisfactory pace". These two reference values,

3% for the deficit and 60% for the debt, are the cornerstones of the EU budgetary framework.<sup>3</sup>

To promote comparability and equal treatment it was agreed to use a common economic accounting system, the ESA, for the compilation of budgetary data. At the time, most countries used disparate conventions in their national economic accounts and the coverage and standards in the public budget accounts also diverged a lot. Today, the ESA is law and all countries must produce full national accounts on the ESA basis.

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The EDP also specifies the reporting requirements and the decisions the Commission and the Council should take if a country does not meet the requirements. Budgetary statistics (and plans for the current year) on deficits and debts must be reported to the Commission by member states twice a year (end February and end August). On the basis of these reports, the Council then assesses the situation.<sup>4</sup> If an excessive deficit is identified, the country receives a recommendation to take action and get back below 3%. At the end of the procedure, if no effective action has been taken in response to the recommendations, the Council may apply various sanctions to the country concerned. (Article 104.11, see also below on the SGP for more details). Sanctions can only apply to countries that are EMU members.

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In connection with the start of Stage Three of EMU in 1999 there was concern that members would relax budgetary discipline once EMU membership had been secured. The formulation of EDP in the Treaty leaves room for discretion on whether or not to take action and there were fears that the difficult decisions would not be taken. Therefore, the EDP was supplemented with the Stability and Growth Pact (SGP).<sup>5</sup> The SGP's overall purpose is to make the EDP more automatic, thus forcing policy makers to take decisions and go through the steps in the procedure in a timely way if a member state fails to abide by the rules and take the stipulated correctives. To this end, the SGP reinforces the EDP by introducing additional preventive and dissuasive elements.

A key preventive element in the SGP is the requirement to achieve a medium term budgetary position that is "close to balance or in surplus". The idea is to build in a safety margin to the 3% ceiling so as to allow for

<sup>3</sup> The relevant deficit is net borrowing. As the ESA did not have a definition of general government debt, this was defined separately but based on ESA classifications of assets. The debt ratio is gross, implying that only government liabilities held within government are netted out. General government comprises central government, state government, local government and the social security sector. In particular, public corporations are not included.

<sup>4</sup> It should be noted that while the statistics are reported by member states, it is the Commission that is ultimately responsible for providing the Council with EDP statistics. The Commission is therefore entitled to revise a figure reported by a member state if this is deemed to be necessary.

<sup>5</sup> The Stability and Growth Pact consists of two Council Regulations (CR) and a European Council resolution: CR 1466/97 introduces the preventive elements of the SGP; CR 1467/97 speeds up and clarifies the implementation of the EDP; the resolution gives the political and behavioural commitments from Member States, the Commission and the Council.

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the budget to play its stabilisation role without going into excessive deficit. In this way it can be argued that budget stringency over the cycle permits flexibility within the cycle.

To illustrate how positions "close to balance or in surplus" are to be achieved and maintained and provide a basis for forward-looking surveillance, euro area members must annually present a stability programme (non-euro area members present similar convergence programmes) outlining medium term budgetary plans. The programmes are assessed by the Commission and the Council. The Council issues an opinion on the programme giving its conclusions.

The preventive provisions also include an "early warning" mechanism. The Commission should notify when divergence from programme targets implies that a risk of an excessive deficit exists and make a recommendation to the Council to recommend that the country concerned acts to avoid an excessive deficit. The draft for a new EU constitution envisages that the Commission shall be able to issue "early warnings" directly to the country concerned without going through the Council. However, the responsibility for the policy advice on what action to take will still rest with the Council.

The dissuasive component of the SGP consists of speeding up the EDP, defining the exceptional circumstances when the deficit may exceed 3% and specifying sanctions. Speeding up is done by setting maximum deadlines for the steps in the EDP. In the standard case, in March of year  $t$  a member state reports statistics on the outcome for year  $t-1$ . If an excessive deficit is reported, it should first be identified<sup>6</sup> and a recommendation for action given together with a deadline for its correction (article 104.7). If the member state takes no action (article 104.8) and persists in failing to do so, a further notice for action is given by the Council (article 104.9). As for the excessive deficit, it should normally be corrected the year after its identification. So, if in 2004 statistics lead to a decision that an excessive deficit existed in 2003, this should be corrected by 2005. The escape clause, "exceptional circumstances", is reserved for very poor outcomes. A deficit above 3% is allowed only if growth is negative and below -2% on an annual basis. The deficit can then only be above 3% in that particular year. However, negative growth below -0.75% entitles the country to raise the issue for discussion.<sup>7</sup>

<sup>6</sup> Article 104.3–104.6. The identification of an excessive deficit takes place against the deficit and debt reference values as described above. That is, whether the deficit is above 3%, if it is, whether it is exceptional and temporary and if the debt ratio is below or approaching the 60% level at a satisfactory pace. In addition, the assessment shall also take government investment into account and the medium term budgetary position.

<sup>7</sup> The EDP allows for the 3% limit to be exceeded in "exceptional circumstances". CR 1467/97 defines "exceptional" as growth below -2% of GDP but it may take into account further evidence provided by the country concerned. In the political declaration on the SGP, Member States agree not to ask the Council to look at further evidence unless growth is below -0.75% of GDP.

If an EMU member is in an excessive deficit for three years in a row then, as a rule, there should be a sanction (article 104.11). The initial sanction would be an interest-free deposit. The financial cost at this stage is the loss of interest on the deposit. The deposit has a fixed component of 0.2% of GDP plus a variable component equal to 1/10th of the distance to the 3% threshold up to a maximum of 0.5% of GDP. If additional deposits are required only the variable component will apply. Hence, if the deficit is 4% of GDP, the deposit is 0.3% of GDP ( $0.2 + 1/10 \cdot (4 - 3) = 0.3$ ). If the excessive deficit is not corrected within two years after the deposit has been made then, as a rule, it is converted into a fine. Note that in the standard case there is plenty of time to address the situation before a deposit becomes a fine. If a country first shows an excessive deficit in 2004 and then also in 2005 and 2006, a deposit would be required in early 2007 and would be converted into a fine in 2009 if the excessive deficit has not been corrected by then. Fines are therefore the end point in a long process primarily aimed at countries that do not take measures or when measures taken are not effective. That is also the argument why the sanctions need to be substantial to have effect.

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These basic rules have been supplemented with agreements on the specification and measurement of key variables and assessment tools. For example, statistical authorities are working continuously to improve the ESA definitions on deficit and debt and make them more complete. This is necessary when it shows that countries use different conventions to record similar items or when the ESA does not give clear guidance on how to record new types of budgetary operations. Agreements have also been made on how to measure what is “close to balance or in surplus” over the cycle (I will discuss this in some more detail below). A lot of work has gone into developing a common method for adjusting budget deficits for the impact of the cycle (“cyclically-adjusted budget balances” or CABs). CABs are used to assess whether or not budget plans conform to the “close-to-balance” requirement. The key problem is that neither the business cycle nor its budgetary impact are directly observable and therefore have to be estimated. The numerous technical problems involved in calculating CABs are discussed by Boije in a separate article in this issue.

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## The events: an overview of economic developments and procedural steps

Budgetary performance during the lifetime of the EU framework has been mixed, across both time and countries. In the period leading up to the assessment of EMU qualifications, most countries made impressive progress towards the budgetary convergence criteria. In 1993, budget

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deficits in EU15 averaged 5.6% of GDP and the debt level 67 % of GDP (Table 1). In 1996, one year before the membership assessment, a majority of the countries still had deficits clearly above the 3% level. But in the following year, which was the basis for deciding EMU membership, the average deficit was down to 2.6%. However, the debt level had moved up to 75% of GDP<sup>8</sup> clearly higher than in 1993. Nevertheless, it had stopped rising and was predicted to decline, which overall was considered to be sufficient to fulfil the convergence criteria also in those countries with debt levels above 60% of GDP. Taking growth conditions and various one-off budget operations into account would not change the overall impression that important consolidation measures were indeed taken.

In the first few years of EMU, the main policy objective was to generate a safety margin to the 3% threshold and reach the SGP's "close to balance requirement". However, when the incentive to acquire EMU membership disappeared, the pace of underlying fiscal consolidation lost momentum. Even so, budget balances continued to improve automatically as growth accelerated above potential rates and the debt interest burden was reduced. In 2000, the average budget position in the EU was a surplus of 0.9% of GDP. However, this included sizeable one-off receipts from the sale of UMTS licences in several countries; netting out UMTS resulted in a deficit of 0.3% of GDP. Eight countries showed budget surpluses. Only Greece, France, Italy and Portugal still had deficits close to or above 1.5% of GDP.

However, the improvement of actual deficits concealed the fact that underlying budgetary positions did not improve as much. Effectively, budget targets set in actual terms were surpassed without difficulty and so as not to be bound by the targets, some countries were arguably over-cautious in their stability programmes. A debate started on how to make the framework binding also in good times. Some commentators, including the Commission, argued that it would be better to pay more attention to cyclically-adjusted budget figures. Nevertheless, maintaining pressure was difficult when actual budget deficits were some way from the 3%-threshold; many countries had been running tight policies for a number of years and were now feeling some "consolidation fatigue". The feeling in many quarters was that the time had come to "reap the benefits" of the many years of building EMU. More attention was paid to increasing the "quality" of public budgets as the room for manoeuvre was seemingly regained. Some countries started to implement useful but costly tax

<sup>8</sup> These figures are on an ESA95 basis. In 1998, at the time of the convergence assessment on 1997 outcomes, the relevant accounting framework was the previous version, ESA79. These figures are therefore not entirely comparable with those used in the assessment in 1998. It can be noted that today the 1997 deficit figures for Spain and Portugal are above 3%, and for France at 3%.



**TABLE 1. BUDGET BALANCE AND DEBT RATIOS TO GDP, SELECTED YEARS 1993–2003**

General government, per cent	Budget balance							Gross debt		
	1993*	1997	1999	2000	2001	2002	2003	1993	1997	2003
Belgium	-7.2	-2.0	-0.4	0.2	0.6	0.1	0.2	138	125	104
Germany	-3.5	-2.7	-1.5	1.3	-2.8	-3.5	-4.2	47	61	64
Greece	-13.6	-4.0	-1.8	-1.9	-1.5	-1.2	-1.7	110	108	101
Spain	-6.7	-3.2	-1.2	-0.8	-0.3	0.1	0.0	59	67	51
France	-5.6	-3.0	-1.8	-1.4	-1.5	-3.1	-4.2	45	59	63
Ireland	-2.3	1.4	2.3	4.4	0.9	-0.2	-0.9	96	65	33
Italy	-9.4	-2.7	-1.7	-0.6	-2.6	-2.3	-2.6	118	120	106
Luxembourg	-1.5	3.2	3.5	6.4	6.2	2.4	-0.6	6	6	5
Netherlands	-3.1	-1.1	0.7	2.2	0.0	-1.6	-2.6	79	70	55
Austria	-4.2	-2.0	-2.3	-1.5	0.3	-0.2	-1.0	62	65	66
Portugal	-5.9	-3.6	-2.8	-2.8	-4.2	-2.7	-2.9	59	59	58
Finland	-7.9	-1.3	2.0	7.1	5.2	4.2	2.4	56	54	45
<i>Euro area</i>	-5.6	-2.6	-1.3	0.2	-1.6	-2.2	-2.8	67	76	70
Denmark	-2.8	0.4	3.3	2.6	3.1	1.9	0.9	78	61	43
Sweden	-11.5	-1.7	1.5	3.4	4.5	1.3	0.2	71	70	52
United Kingdom	-7.7	-2.2	1.1	3.9	0.7	-1.5	-2.8	45	51	40
<i>EU</i>	-6.0	-2.5	-0.7	1.0	-0.9	-1.9	-2.7	65	71	64

Source: European Commission.

\* On ESA 79 basis.

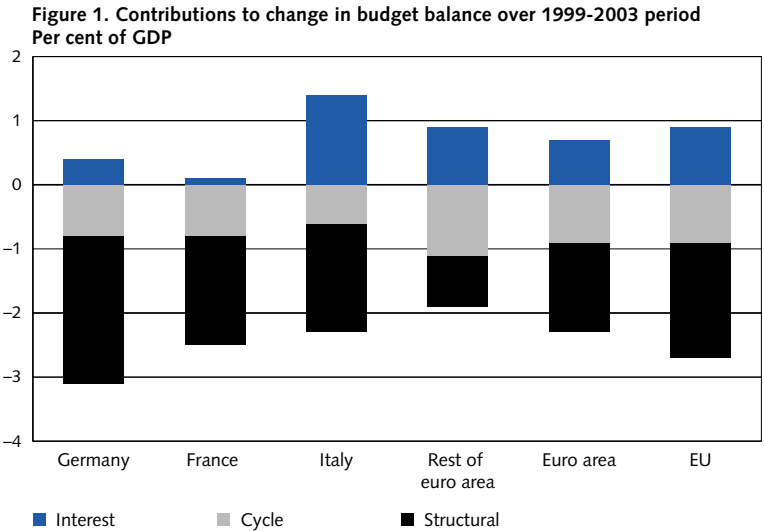
reforms (for example Germany) that at best were only partly funded and which turned out to have a permanent negative impact on the budget.

To be fair when assessing the lack of consolidation during these years it should be taken into account that the bright economic outlook in 2000 was a general perception and not only a biased interpretation by the member states concerned. For example, in the 2001 outlook in the Commission's Public Finance Report of 2000 (presented in spring 2000), potential growth rates in the euro area were estimated to be around 2.5% of GDP and growth in 2001 was forecast at 3.1%. We now know that growth amounted to only 1.5% and current potential growth estimates are closer to 2%.

With hindsight, the lack of pressure for continued consolidation and proper funding of reforms during the "good years" underlies many of the problems that have emerged in recent years. Still, a distinction should be made between countries. There is a clear difference between smaller and the larger member states, making up the bulk of the EU economy. In the larger member states consolidation efforts have been less ambitious. Figure 1 shows the contributions to the change in the budget balance over the 1999-2003 period stemming from: 1) the reduction in the interest burden, 2) the estimated impact of the cycle and 3) other non-cyclical factors ("structural" in the figure). In all member states, budget balances have benefited from the reduction in the debt interest burden explained

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by the impact from lower interest rates (in particular high debt countries like Italy). On the other hand, the downturn has implied that cyclical tax revenues have decreased and unemployment expenditures increased. Structural developments have also contributed to increase deficits. Such factors may be expansive fiscal policies and underlying trends on the government expenditure and revenue side. The negative budget impact from structural factors is substantially higher in the large countries than in the rest of the euro area thus indicating a lack of consolidation efforts in these countries.



Sources: Own calculations and the European Commission.

Programme targets have been continually undershot in connection with growth assumptions that have turned out to be optimistic while policies have often continued to be expansive.

As said above, growth slowed markedly in the second half of 2001 and since then the downturn has continued. As a result, budgetary positions have deteriorated and the weakness of underlying budget positions has started to surface. A general observation is that many member states, instead of resuming consolidation, have gambled on a relatively quick turnaround in the business cycle that would save the day. This has not happened and in several countries with an inadequate safety margin, deficits soon approached the 3% limit again. In contrast to earlier years, programme targets have been continually undershot in connection with growth assumptions that have turned out to be optimistic while policies have often continued to be expansive (maybe in particular in 2002). A cynic might observe that in their assessment of budget outcomes, member states have been more prone to take the cycle into account in the downturn than they were in the previous upturn.

But while the gradual accumulative loosening of fiscal positions since

the start of the SGP should not be glossed over, it can be noted that the euro area fiscal stance (measured as the annual change in the cyclically-adjusted primary balance, see Boije) has been more or less neutral ( $\pm 0.5\%$ ) over the period. Thus, the pact has been successful in the sense that fiscal policy in the euro area has not been overly unbalanced and burdened monetary policy.

Signs of procedural alarm started to show early in 2002 as the first steps were taken to implement the SGP. Early that year the Commission proposed that the Council should issue an “early warning” to Germany and Portugal that their deficits were quickly approaching the 3% limit. The Council, however, decided not to follow the Commission’s suggestion. There were several reasons for this, one being that this was the first instance of such a warning and the political signal would be strong. In particular, elections were due in Germany and the government there sent clear signals that a warning would not be welcome, while fellow ministers within the Council were reluctant to cause a disturbance. Moreover, it is probably fair to say that many smaller member states believed they would benefit from not warning Germany because it would then be more difficult to give them a warning should such a situation arise. However, by autumn 2002 it was already clear that both Germany and Portugal would breach the 3% deficit limit and the situation in France was deteriorating rapidly.

After this, things moved quickly in 2003 and given the attention they have received, it may be worth describing the main procedural events. An excessive deficit was established for Portugal in November 2002 and for Germany in January 2003. France received an “early warning” in January 2003 and an excessive deficit was established in June. All three countries were told by the Council to take action to get the deficit below the 3% threshold, in 2003 for Portugal and in 2004 for Germany and France. Germany presented measures worth some 1% of GDP in spring 2003. Towards the autumn of 2003, however, it was clear that the German efforts had not had the desired effect on account of some budgetary slippage and a further deterioration of growth conditions. Moreover, the 2004 budgets, presented during autumn, showed that Germany and France would fail to get below the 3% limit in 2004 as required. At this stage the Commission asked the Council to issue a new recommendation to the two countries, requesting further action on top of that included in the 2004 budgets while at the same time postponing the deadline for getting below 3% one year, to 2005, in view of the weak economic outlook.

However, at the meeting on 25 November the Council decided not to adopt formal recommendations and instead put the procedure on hold.

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The decision was not unanimous. Most of the smaller member states (incidentally usually fulfilling the “close to balance” requirement) voted in favour of the Commission's recommendation but the larger countries (France, Germany, Italy and the UK) formed a blocking minority. In contrast to the proposed “early warning” to Germany and Portugal in early 2002, it may be speculated that on this occasion especially the smaller member states appreciated the Pact as an instrument for exerting pressure on the larger member states.

**Instead of a recommendation, the Council stated that Germany and France should take some action and get below 3% in 2005.**

Instead of making a recommendation, the Council adopted conclusions to the effect that Germany and France should take some action and get below 3% in 2005; this broadly corresponded to what the Commission had requested. The crucial point is procedural. Had the Council adopted the Commission's recommendation and France and Germany had failed to comply, the next step would have been sanctions in the form of a deposit (which may be converted into a fine after two years if the deficit remains excessive). In that the formal procedure was dropped in favour of an intergovernmental agreement, the increased pressure inherent in moving closer to sanctions did not materialise. The Commission has asked the Court of Justice to bring clarity to the procedure by assessing whether the Council had the right to take this decision in this format.

**The updated stability and convergence programmes point to an average euro area deficit in 2004 of about 2.4% of GDP.**

Turning to future prospects, updated stability and convergence programmes were presented by member states late in 2003. The budgetary outlook is not that bright and many member states may approach or remain in the risk zone. According to the programmes, the average euro area deficit in 2004 will be about 2.4% of GDP. France and Germany target deficits above 3% of GDP and Italy, the Netherlands, Portugal and the UK above 2%. For 2005, all countries have targets below 3%. Only the Nordic countries project surpluses. In the subsequent years a gradual improvement is foreseen towards deficits of 1% on average in the euro area. However, growth assumptions are relatively optimistic, above potential growth rates, implying a risk of negative surprises. Thus, tensions around the deficit ceiling will probably persist for a couple of years unless there is a strong economic recovery.

## **Assessing the Pact's functional performance: the design and specification of rules and figures and mechanisms for implementation**

A credible and effective rule-based framework is characterised by well-designed rules and strong enforcement mechanisms. Against this background, the qualities of the EU rule-based framework have been assessed

and discussed in several contributions.<sup>9</sup> Below are some comments on: (i) the design of the numerical rules; (ii) aspects of the technical specification of statistics and rules, and (iii) implementation procedures and enforcement mechanisms.

## THE DESIGN OF THE EU NUMERICAL BUDGET RULES

A credible numerical rule has a number of desirable features (Kopits (2001), European Commission (2001, 2003)). First, a good rule should be adequate in the sense that it contributes to the desired policy goals while being consistent with other policy objectives. Second, it should be operationally simple, that is, easily understood, well defined, transparent and enforceable. Third, it should be flexible so that it is sufficiently robust to apply to changing economic circumstances. At the same time there are trade-offs. Simplicity may come at the expense of flexibility. A high degree of adequacy may require relative complexity at the expense of simplicity. Also, a high degree of flexibility may make a rule less enforceable. These trade-offs and the weight assigned to different features are often at the heart of the debate. Unfortunately, no rule is perfect and a choice has to be made.

A recognised strength of the EU numerical rules is their relative simplicity. The deficit and debt rules are straightforward and easy to communicate to the public. As concepts, deficit and debt are clearly defined in the ESA. The close-to-balance rule over the cycle is more difficult to define but nevertheless easy to understand and communicate conceptually.

The debate has focused more on the rules' degree of adequacy and flexibility. On adequacy it is often pointed out that the 3 and 60% reference values are ad hoc and lack a scientific foundation.<sup>10</sup> Nevertheless, the rules are arguably adequate in the sense that the combination of a deficit ceiling, a debt target and the close-to-balance objective promotes budgetary prudence and reduces the risk of unsustainable budget positions.

Criticisms follow two lines. On the one hand it can be argued that the rules are too harsh. If a position close to balance over the cycle is upheld, then in the long-term the rules imply that debt ratios will converge to zero, which seems overambitious.<sup>11</sup> On the other hand, the actual deficit and the definition of debt do not capture the cost pressures

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**The debate has focused more on the rules' degree of adequacy and flexibility.**

**The rules may be too lenient and short-term and do not efficiently address long-term sustainability.**

<sup>9</sup> Notably, in November 2002, the Commission presented a Communication on this topic. Other contributions, to list a few, are Buti et al. (2003), EEAG (2003), and Fatas et al. (2003).

<sup>10</sup> It has been argued that the values were chosen because at the time of the Maastricht treaty these figures represented the current average deficit and debt ratios. Another justification has been that the deficit and debt values are internally consistent in that with 3% deficits, 2% inflation and 3% real trend growth, the debt ratio will converge to 60%  $(0,6/(1+0,02+0,03)+0,03\%=0,6)$ .

<sup>11</sup> If the deficit is balanced over the cycle, it will be zero on average, implying that the ratio of debt to GDP will converge to zero as the denominator GDP grows.

associated with ageing. The expected future increases in pensions and health care are not yet reflected in today's budget balance. It is rather the case that today's budget balance benefits, in that most pension systems still show a surplus.<sup>12</sup> Moreover, the definition of debt does not include the contingent liabilities inherent in future pension commitments. In this way the rules may be too lenient and short-term and do not efficiently address long-term sustainability.

Another criticism has been that the deficit rule does not allow productive investments to be treated differently from government consumption and that this represents a negative incentive for government investments (as it often is the easiest to restrict in the short term from a political perspective)<sup>13</sup>, running counter to the general ambition to increase investments.<sup>14</sup> It is suggested that a budget balance rule net of capital investment could be used instead (the "golden rule"<sup>15</sup>). The counterargument is that, given the need to reduce debt, investment is better financed by adjusting expenditure priorities below the deficit limits rather than on top. A technical problem with treating investment separately in the rule is that the national accounts definition of investments relates to physical investment (roads, buildings etc.), which is too narrow a concept for policy purposes (consider, for example, investment in human capital). A numerical rule on this basis would therefore give biased incentives across classes of investment.

Arguments about the flexibility of the rules also differ. The deficit ceiling is criticised for being fixed and set in nominal terms, so that it does not vary with the cycle. A country with a budget problem may therefore have to take pro-cyclical measures in bad times to stay below the ceiling. However, this argument is limited since the close- to-balance requirement, if achieved, should allow the budget balance to fluctuate freely over the cycle without exceeding the limit.<sup>16</sup> In this way it may be argued that the

The deficit ceiling is criticised for being fixed and set in nominal terms, so that it does not vary with the cycle.

<sup>12</sup> For example, in Sweden the general government budget balance is now in surplus, despite deficits at general and local government level, because the surpluses in the government pension systems amount to 2% of GDP.

<sup>13</sup> Support comes from the fact that in the EU the ratio of general government investment to GDP has shown a declining trend since the EU framework was set up. However, the driving forces behind the decline in government physical investment are very difficult to assess because they have to be seen in the context of overall investment in the economy, the need for additional government physical investments and new financing options (for example public-private partnerships). Even so, there is some evidence that in the run-up to EMU, some countries consolidated their budget positions through reductions in investments.

<sup>14</sup> Increased investments are part of the Lisbon agenda for higher growth in the EU. The argument may be stronger in relation to the new member states, where – given the process of catching-up – the need for government investment is relatively greater than in the current member states.

<sup>15</sup> The "golden rule" is that consumption should be financed through taxes paid by the current generation, while investments can be debt-financed by future generations as they consume the benefits from the investments.

<sup>16</sup> If GDP growth is 1 percentage point below the potential rate, on average in the EU the estimated impact on the budget balance is 0.5% of GDP. Thus, with a 3% safety margin to the threshold in normal circumstances, GDP growth can be 6 percentage points below the potential rate before the ceiling will be passed ( $6 \times 0.5 = 3$ ). An output gap of 6% implies a very severe downturn.

rules allow for stringency over the cycle but flexibility within the cycle. But, of course, there is a time inconsistency problem here in that, to avoid pro-cyclical policies in bad times, the close-to-balance requirement must be reached in advance when times are good. This indicates that to be consistent, the rules may benefit from stronger incentives to behave well in good times, something that will be further discussed below.

Another aspect of flexibility is “escape clauses”. The EU framework is very tight; the deficit may exceed 3% only if growth is markedly negative (“exceptional circumstances”). Note that growth during the downturn in recent years has been positive and not even close to being “exceptional”.<sup>17</sup> Neither can the rules be easily overridden or changed as they have a legal base. Thus, the escape clauses are very tight, implying that the rules are operating under most circumstances. It may even be asked whether the escape clauses are too tight to be credible? For example, it may appear to be more logical to relate what is an exceptional situation to the output gap, which measures the overall position of the economy in the cycle. Negative growth in a situation with a positive output gap is a different matter from negative growth when the gap is also negative. Also, several years of weak growth can be more severe than one year of very poor growth. Again, 1% positive growth in an economy with a 5% growth potential may be worse than slightly negative growth in a country with a low growth potential. Relating to the output gap would also be consistent with the general approach of analysing the public finances more closely in relation to the cyclical position. On the same time of course, there is the measurement problem that the business cycle is not observable.

Another debated issue is that the EU deficit and debt ceilings apply uniformly to all member states, regardless of their general economic situation. The argument for this is that all member states face similar challenges as regards the need for further consolidation and reduced debt levels. Against this it can be said that a country with a very low debt level or only minor ageing problems should not be subject to the same limitations as a country with high debt and major pension problems. Applied uniformly to countries in similar situations, more flexible rules could cope better with different economic circumstances. This will be discussed more in detail in the last section. With 25 member states this consideration may be an even more important.

**Another aspect of flexibility is “escape clauses”.**

**Another debated issue is that the EU deficit and debt rules apply uniformly to all member states, regardless of their general economic situation.**

<sup>17</sup> However, growth in Portugal in 2003 may have been close to -0.75, allowing Portugal the right to argue that the 2003 deficit outcome, if above 3%, was exceptional. In the 2004 stability programme, Portugal gives a figure of -2.9% for 2003. An official outcome figure will be reported in the EDP at end February.

## TECHNICAL SPECIFICATION OF FIGURES AND OUTCOME ASSESSMENTS RELATIVE TO THE RULES

<p><b>Efficient and credible numerical rules should be clearly defined and enforceable.</b></p>	<p>Efficient and credible numerical rules should be clearly defined and enforceable. With numerical rules, the procedure is driven by numerical compliance. Since the figures trigger semi-automatic decisions taken with tight deadlines, there are incentives for “creative accounting”. Creative accounting implies that in order to reach a target, a country resorts to a budget operation on its statistical rather than its economic merits. There is also an asymmetry of information across countries. Each country has very detailed knowledge about its own economy but less about others, even though the Commission provides support with analysis and surveillance. In this setting, a common technical ground on which decisions can be taken is important also for equal treatment. Thus, in the SGP the technical specifications of figures and rules have become particularly important.</p>
<p><b>Work is being done continuously to streamline and improve the quality of deficit and debt figures.</b></p>	<p>Work is being done continuously to streamline and improve the quality of deficit and debt figures.<sup>18</sup> Eurostat, the statistical arm of the Commission, is the responsible authority. Member states’ statistical offices and central banks contribute through the many committees and task forces that have been set up for this purpose alone. Member states’ figures are continuously assessed in connection with each EDP report. There is also a cycle of country missions whereby the Commission calls on member states to discuss the EDP statistics. Moreover, member states may consult Eurostat if there is uncertainty about how to record a specific transaction according to the ESA. If recording issues have EU-wide implications, task forces are set up to address them.</p>
<p><b>Efforts are still required to improve the statistical material for EDP decisions.</b></p>	<p>Despite progress, efforts are still required to improve the statistical material for EDP decisions. This applies in particular to the end-February reporting, which is the first reporting of outcome figures for the previous year and thus the key phase of the EDP procedure. However, in February statistical offices often do not have a full data set (especially not on local government developments), a considerable proportion of the statistics may be estimates and it is not uncommon that the figures have to be revised substantially in the September reporting. Another issue is the provision of methodological guidance from Eurostat. It is important that this is done quickly in order to avoid uncertainty. However, decisions involve consultation procedures with member states and the time lag before they are made has often been long. Still, measures have been taken to speed this procedure up and it should now take not more than six weeks.<sup>19</sup></p>

<sup>18</sup> For an overview of the statistical work done in the EDP context in recent years and a discussion of challenges, see European Commission (2003).

<sup>19</sup> On 18 February 2003, the Ecofin Council agreed a “Code of best practice” for the compilation and reporting of EDP data (COM (2002) 670 final).



The conceptual ESA recording questions tend to concern three dimensions: the delimitation of general government, the financial/non-financial nature of a transaction and the time of recording a transaction. In national accounts a distinction is made between the government acting in its role as public administrator and as a corporation. Public corporations are accordingly classified in the corporate sector and do not form a part of general government. Classification questions have arisen as regards special government entities set up to manage or sell government assets (for example buildings or the privatisation of public corporations). Also, there are many transactions and flows between government and public corporations where it is not always clear whether they are financial flows (with no impact on the deficit) or transfers (with an impact on the deficit). For example, if the government makes a large payment to a public corporation presented as a purchase of shares, it may still not be clear whether this should be recorded as a financial transaction or a transfer. Normally, the purchase of shares is a financial investment but if the operation is merely a way to cover for losses it is another issue. Conversely, if a government corporation makes a large payment to the government, is this a dividend (non-financial) or a withdrawal of equity (financial)? It depends on what can be regarded as a normal dividend. Similarly, it may be unclear whether a government payment to a private corporation presented as a loan is in reality a grant. It depends on the terms. As a general principle, the key issue to analyse is who takes the real economic risk, that is, whether or not the government payment/receipt can be defended on business grounds.

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A problematic issue has been the practical application of the accruals principle, which states that transactions are recorded at the time of the underlying economic event, not at the time of payment. For example, if the government makes a large investment that extends over five years, the recording in the accounts should be spread over the five years regardless of whether actual payments are made up-front, after or during the period. Without payments data, however, it can be difficult to know what amounts to record. This increases uncertainty and the likelihood of large statistical revisions. A pertinent example is corporate taxes, which are often collected the year after the income year to which they refer and are liable to fluctuate considerably from year to year.

**A problematic issue has been the practical application of the accruals principle.**

Another technical issue has been how to make operational the medium-term target of being "close to balance or in surplus", as required in the SGP. The issue involves two questions. First, how to interpret what is meant by the medium term. Second, how to assess what can be considered "close". As regards the first issue, the approach used is to look at what the annual budget balance is if the medium term budgetary impact

**Another technical issue has been how to make operational the medium-term target of being "close to balance or in surplus over the cycle".**

of the business cycle is neutralised. An alternative approach could be to simply take the average budget balance over the cycle. An important difference between the two approaches is that with the first approach it is possible to make up for current deficits by aiming for higher surpluses in the future, so that consolidation can be continuously rolled over. Alternatively, high surpluses in the past can be used to cover for large deficits today.<sup>20</sup>

On the second question, as said earlier, the logic behind this requirement is to have a sufficient safety margin to the 3% threshold. The issue has been how large such a safety margin needs to be to be considered "close". It has been estimated that a safety margin around 2–3% is sufficient to allow the automatic stabilisers to operate freely even in rather severe downturns and make some accommodation for budget surprises (see footnote 16 and European Commission (2000), (2001)). The current understanding is that the target should be understood as balanced budget in cyclically-adjusted terms (=0) but to allow for measurement uncertainty a medium-term balance of –0.5% is regarded as sufficient. Of course, a country may consider that a more ambitious medium term target is more appropriate taking into account the expected budgetary impact of ageing and preferences for additional room of manoeuvre for fiscal stabilisation policy (Eckefeldt & Fischer (2002)). For example, with a reference to such arguments the Swedish government target a 2% surplus over the cycle.

Lastly, one of the most debated issues has been the best way of adjusting the budget balance for the cycle.

Lastly, one of the most debated issues has been the best way of adjusting the budget balance for the cycle, that is, how to calculate the cyclically-adjusted budget (CAB) position, a key indicator in the SGP. As already said, neither the business cycle nor its budget impact is directly observable and needs to be estimated. In the EU, for reasons of equal treatment, the aim has been to develop a single method that is applicable to all countries and can be used as the basis for the common assessment. Consequently, the agreed method should not be unduly complicated, neither can it take country-specific elements into account.<sup>21</sup> At the same time, most countries have their own methods and CAB figures are also provided by other international institutions, such as the OECD and the IMF. This leaves room to debate results, especially when different methods give different policy conclusions. The unavoidable dilemma is that

<sup>20</sup> This distinction is pertinent in relation to the assessment of the national 2% surplus target over the cycle applied by the Swedish government. In the 2004 budget, the government assesses the 2% target by taking the average surplus over the period 2000–06. This gives a surplus of 1.7% (given the large surpluses in 2000/2001), which is deemed to be in compliance. However, the cyclically-adjusted budget balance in 2004 is only around 1%, quite a way from 2%.

<sup>21</sup> To estimate the cyclical budget component, the output gap is multiplied by a set of revenue and expenditure elasticities to the output gap. The production function has been agreed between member states and the Commission, while the elasticities have been calculated by the OECD (see European Commission (2002a??b??c??)).

while no CAB figure can be more than indicative, giving a broad picture of trends over time, the application of the numerical rules requires certainty about the precise annual figures in order to assess compliance with numerical targets. Development work on the CAB estimation methods continues but there is no way round this fundamental dilemma. Possibly, rather than putting more effort into making marginal technical improvements to a single indicator that will never be more than a rough pointer, it may be preferable to develop a common analytical framework for how to assess underlying budgetary trends, taking many indicators into account.

#### PROCEDURES AND MECHANISMS FOR IMPLEMENTATION AND SURVEILLANCE

One of the framework's key deficiencies has been the poor implementation record. Good implementation requires efficient surveillance, follow-up procedures and enforcement mechanisms. As outlined above, the main procedures for surveillance and follow-up are the steps in the EDP procedure, the handling of the cycle of stability and convergence programmes and the early warning mechanism in the SGP. The main enforcement mechanism is peer pressure coupled with sanctions. During the first years with the Pact, the practical application of the procedures has been developed step by step in a process of learning by doing.

**Good implementation requires efficient surveillance, follow-up procedures and enforcement mechanisms.**

As regards the EDP, the full procedure has not yet been applied. In the years of the convergence process leading up to EMU, most countries were in an excessive deficit position but then the sanctions part of the EDP was not in force. The cases against Portugal, France and Germany have gone furthest in the procedure, stopping one step before sanctions (as decided by the Council on November 25). Leaving this experience aside, it must be said that from a procedural perspective the EDP has been working; reports and decisions have been taken within the time-limits specified in the legislation. Nevertheless, how to go forward on each step has not always been clear and there has been room for discussions at legal level. Nevertheless, today there is some "case law" to refer to. Further clarification will be provided by the forthcoming ruling of the Court of Justice.

**From a procedural perspective the EDP has been working; reports and decisions have been taken within the time-limits specified in the legislation.**

Concerning the reporting of data in the EDP, a major issue in the years leading up to 1998 was the quality and timeliness of the data. Today, most countries have no difficulty in delivering the required data on time and delays, if any, are small. Even so, at times revisions are still

important<sup>22</sup>. However, reporting is still an issue as regards the new member states that will formally report data for the first time in February 2004. The “early warning” mechanism has not worked well and could be improved: to be effective it needs to be more forward looking and “daring”.

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One problem with the EDP procedure may have been that, because it operates on outcomes rather than forecasts, the formal procedure starts too late. The SGP “early warning” mechanisms have a role to play here. In principle, a country should be given an early warning if a significant divergence from plans implies a risk of an excessive deficit. The Commission’s initiative to propose that Portugal and Germany should receive an early warning in early 2002 failed since the Council did not act on the proposal. Later, France has been given early warning. Generally, the early warning procedure has been initiated too late, relating more to outcomes than plans, and not early enough to have an impact on the budget. In this sense, the “early warning” mechanism has not worked perfectly and could be improved; in particular it must become more forward looking and “daring” to be effective.

In July 2001, the Council agreed on a new “code of conduct” to improve the content and comparability of the programmes.

The cycle with stability and convergence programmes is the main surveillance procedure and is gradually becoming more streamlined (see Fischer & Giudice (2001)). In July 2001, the Council agreed on a new “code of conduct” to improve the content and comparability of the programmes. Member states submit their programmes in a cluster towards the end of the year and the content has a common structure and coverage. The programmes should describe medium-term budget plans, give information on the overall strategy, specify measures and structural reforms and deal with the long-term implications of ageing. With reference to equal treatment, the Council produces conclusions on all programmes (though it is not required to do so). Programmes are public, as are the Council’s conclusions and now also the Commission’s assessment. However, the arrangement means that the Council and Commission have to deal with 15 programmes (soon to be 25) at basically the same point in time, which is a challenge if the exercise is to remain in depth.

The main enforcement mechanisms are peer pressure and the application of sanctions.

The main enforcement mechanisms are peer pressure and the application of sanctions. Peer pressure presupposes that member states are willing to accept it and exert it responsibly with the common good in mind. The history of the Pact shows that peer pressure has not been used

<sup>22</sup> A noteworthy example relates to the 2001 deficit in Portugal. In February 2002 Portugal reported a deficit of 2,2% of GDP for 2001. In July the same year, after a revision of the figures (made by a task-force led by Bank of Portugal), the Portuguese authorities revised the figure upwards to 4,1% of GDP, 1,9% higher! The figure was confirmed in the September EDP reporting. Most of the revision was due to a new way to record tax receipts (i.e. recorded taxes must not be higher than collected taxes). In November 2002, the Council decided that an excessive deficit existed in Portugal.

effectively to protect the framework. The Council has not exerted enough pressure in good times and have not been able to take difficult decisions that went against the larger member states in bad times. Clearly, the 25 November decision weakened the credibility of peer pressure as an enforcement mechanism and questioned whether financial sanctions are ever to be applied. With this decision as a guide and knowing that equal treatment is crucial, it is difficult to see how the situation can be rectified in the short term as the Council may have lost the “benefit of the doubt” to external observers. In time, with good behaviour and firm action when necessary, credibility can be restored.

A possible way to address the lack of credibility is to transfer the power to assess compliance with the rules and decide sanctions from the Council to a neutral third party. This may contribute to solve the incentive problem that arises because member states both decide the rules, form budget plans and, through the Council, assess these plans and decide on compliance and sanctions. The third party could for example be the Court of Justice (see EEAG (2003)). Alternatively, an enhanced role could be assigned to the Commission or to some “council of independent experts” which also have been suggested. An argument for such a separation between politics and technical implementation of fiscal policy is that this has already successfully taken place with monetary policy, so it could also be done to areas of fiscal policy. A counterargument however is that unlike monetary policy, where a single instrument (the interest rate) is assigned to achieve a single target (price stability), fiscal policy measures are usually more complex with have many different simultaneous objectives that need to be reconciled in a political process. Overall, the political acceptance of such a transfer of power appears low at the moment and the democratic validity therefore remains questionable. Even so, there is an ongoing debate on whether and how, in particular fiscal instruments for stabilisation policy, can be separated from other fiscal measures and assigned to a “technocratic” rule<sup>23</sup>.

**A suggestion has been to introduce an external body to decide sanctions, for example, the Court of Justice.**

<sup>23</sup> Such a separation was elaborated on in the Swedish government report on stabilisation policy in EMU (SOU 2002:16). A further discussion can also be found in the Swedish Riksbank views on the report. It is for example suggested that the VAT rate could vary as a stabilisation tool or alternatively the tax on capital income (the latter would change the real interest rate after tax similarly to a change in nominal interest rates).

## What issues are likely to stand in focus in a debate on changes to the Pact?

On the basis of the deliberations above, some areas can be identified that are likely to be in focus in an upcoming discussion on reforms to the EU budgetary framework.

A first priority may be how to strengthen the link between the rules and the assessment of long-term sustainability.

A first priority may be how to strengthen the link between the rules and the assessment of long-term sustainability. The degree to which sustainability is achieved can be more directly reflected in the budgetary restrictions implied by the rules. An obvious possibility would be to directly link the deficit ceiling to the debt level so that an overachievement of the debt target implies a less restrictive deficit ceiling. Another possibility would be to more actively use the excessive deficit procedure when the debt ratio is not decreasing at a "satisfactory pace" (even if the deficit is below the ceiling). Of course, this requires a more elaborated definition of what a "satisfactory pace" actually is, especially for high debt countries. Indeed, a perceived problem so far has been that the rules have not put enough pressure on high-debt countries to reduce debt or on countries with pension problems to enact reform. Instead, countries are caught in the net on account of short-term budgetary problems.

In this context, a technical aspect to be addressed concerns a more complete assessment of debt sustainability. The concept of government liabilities used in the assessments may be made more comprehensive, going beyond current financial debt to include also contingent liabilities, in particular those linked to the ageing of populations. This however requires that efforts are made to identify and measure contingent government liabilities, currently not recognised in the national accounts.

Moreover, account could be taken that potential growth is estimated to be substantially lower than when the Maastricht Treaty was signed. In the long-term, potential growth rates are likely to be even lower, given the impact of the ageing process. Lower growth rates imply greater difficulties in servicing a given level of debt. To illustrate, if 60 % of GDP is assumed to be a sustainable debt level, then with 3 % deficits on average, 2 % inflation and a potential real growth rate of 2 %, debt ratios will converge to 78 % of GDP (rather than 60 % as is the case with 3 % real growth, see footnote 10). Alternatively, to remain consistent with a 60 % of GDP debt level, deficit requirements should be made more ambitious. Lower potential growth rates will also feed into lower growth of tax bases and thus increased pressure for expenditure reform and/or increased tax rates. Overall, public finances will be under additional strain and there will be growing pressure for reform to adapt welfare systems.

Secondly, how to introduce more flexible rules and country-specific

elements in the framework will be an issue. However, flexibility must not be an end in itself but be linked to the level of overall sustainability. As argued above, a low debt may allow for less restrictive deficit rules. Beyond debt, country differences in potential growth rates could also be integrated in the equation. All else equal, a member state with a high potential growth rate will be able to service a higher debt ratio than a country with a low growth potential. In particular, the new member states tend to have substantially higher potential growth rates than the core of the current EU members.

Country specific elements could also be taken into account by allowing more discretion in the assessments, integrating quality aspects such as sources of financing and links to structural reform. A high-quality budgetary strategy could be a reason to allow a higher risk of an excessive deficit. A main difficulty, of course, would be to clearly identify and measure the impact of such aspects. Moreover, a higher weight on medium-term budget trends over the cycle rather than annual changes in actual deficits within the cycle could introduce more short-term flexibility.

Thirdly, the preventive elements should be strengthened, in particular the incentives to behave well in good times. This is crucial since experience shows that it is a lack of stringency in good times that often lies behind the problems in bad times. Both carrots and sticks may be envisaged. A stronger link between long-term sustainability and the deficit restrictions could be used to improve incentives. A lack of sustainability would be a reason for maintaining pressure all over the cycle while a high degree of sustainability would be a reason to be more lenient. Furthermore, a focus on budget balances net of the cyclical impact could help identifying pro-cyclical expansions and thus promote incentives to behave well in good times.

A complementary track may be to introduce sticks in good times. As a thought, rather than applying sanctions for large deficits in bad times, it may be an idea to apply sanctions for not having strong enough balances in good times. In good times resources are relatively more ample and sanctions would in theory be counter-cyclical rather than pro-cyclical. However, in good times rallying political pressure is more difficult. In addition, the negative spillovers appear when deficits are high which tend to be in bad times. It will thus be in bad times that there is a clear mandate for the centre to impose restrictions on the national level.

In any event, it is imperative that the preventive component of the framework is strengthened so that major problems are signalled in good time. In particular, the “early warning” mechanisms must ensure that problems are highlighted early enough for there to be time in which to act. This may imply that forecasts, with all their inherent uncertainties,

**Secondly, how to introduce more flexible rules and country-specific elements in the framework will be an issue.**

**Thirdly, preventive elements must be strengthened, in particular the incentives to behave well in good times.**

Fourthly, the mechanisms of peer pressure and sanctions as the anchor for credibility need to be seen over.

rather than outcomes, could play a greater role as a trigger in the system. Also, the country surveillance could be strengthened. One aspect is that countries with short-term budgetary problems tend to be in focus, crowding out the time spent examining other countries. This risk neglecting countries that look unproblematic in the short-term while in reality it is exactly then peer pressure should be exerted to avoid future problems.

Fourthly, the mechanisms of peer pressure and sanctions as the anchor for credibility need to be seen over. A lack of obvious alternatives means that this may be the most difficult area. The Council's "political ownership" and responsibility for the overall framework needs to be strengthened. But this is probably feasible only through proven action, which will take time even if there may be opportunities of showing strength already in the short term as several countries still have budgetary problems. Another possibility would be to look for alternative mechanisms such as allowing a third party certain powers within the framework. However, as discussed earlier, politically this does not seem to be a feasible way forward at the moment. Even so, a strengthened third party that assess situations and give advice that calls for a public response from member states could be possible. In principle, such a third party already exists in the form of the Commission.

As regards sanctions, it may be that the current system of sanctions appears to "draconian" to be credible. It has always been a concern that the fines are so heavy that they will never be applied in practice. Recent experience seems to confirm this even though it may be argued that making an interest free deposit is not a very heavy sanction. Nevertheless, the SGP may have appeared to have worked as somewhat of a 0 or 1 game: "no problems" or "heavy sanctions". The marginal step to apply sanctions could be too large. An alternative could therefore be to have a more gradual sanction system where a member state quickly has to pay a financial sanction. For example, if a country is not at "close to balance" some sanction could automatically be given. The sanction should be small in the beginning but then gradually increase as the situation worsens. This may reduce the reluctance to impose sanctions at the initial stage and simultaneously provide more direct incentives to show budgetary prudence in general.

However, if all the considerations above would be included in a reformed framework the degree of complexity would increase substantially. Therefore, the possible advantages from introducing changes must be weighted against the need to keep the framework simple, transparent and enforceable. The value of safeguarding the simplicity in the current framework should not be underestimated.

Another issue to consider when making proposals for changes is the



available room for manoeuvre in practice. It is one thing to make suggestions irrespective of the current framework. However, the Excessive Deficit Procedure is a part of the Treaty and has been incorporated as it stands in the Convention's draft for a new EU constitution. There are no plans to change this in the on-going intergovernmental conference, so it is a limitation that must be taken into account. Introducing reforms by amending the secondary legislation of the SGP might be "easier". This has been firmly rejected to date in view of the prospect of difficult political negotiations and the risk of losing what has been achieved if "Pandora's box" were to be opened. However, if the current legal framework must be left unchanged, then only marginal changes confined to the framework's interpretation appear possible. In the current situation it seems necessary to be open for relatively substantial changes.

In the end, as a general reflection given the many trade-offs and fiscal policy objectives, it might be worthwhile to limit the expectations on what the framework should do. Broadly speaking, in the current set-up the deficit rule has to carry many burdens. Besides being expected to provide good incentives to promote sustainability it is expected to generate incentives to behave well in both the long and the short term, as well as in both bad times and good; moreover, it should contain incentives to enact structural reform, raise investments while being fiscally prudent, etc. As a rule, a single instrument cannot be designed to solve multiple objectives that are not internally consistent. The task assigned to one target to deliver on all these policy aspects has led to long arguments about how best to compile indicators, depending on the most pressing policy objective at hand. To some extent, these technical discussions have crowded out the policy debate. In some ways, the mechanics has become policy and policy has become mechanical. Credibility would be enhanced by not aiming for more than can actually be delivered.

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