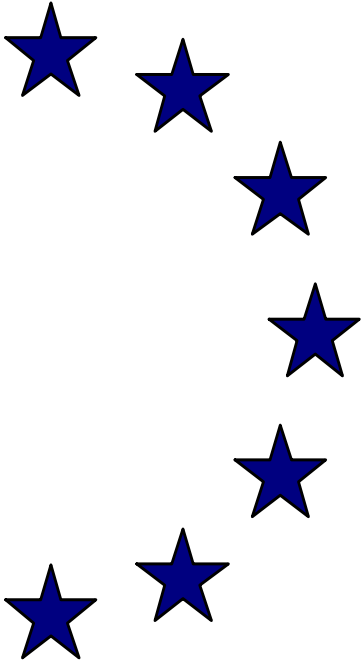


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**Will the New Stability and Growth  
Pact Succeed?  
An Economic and Political Perspective**

by

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# Will the New Stability and Growth Pact Succeed?

## An Economic and Political Perspective

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### 1. Introduction

While the Maastricht Treaty establishes the entry conditions for Member States to join the single currency, the Stability and Growth Pact (SGP) aims to make budgetary discipline a permanent feature of EMU. Consequently, the Pact is commonly interpreted as a major building block of EMU's architecture: the SGP 'must rank as one of the most remarkable pieces of policy coordination in world history. Its construction makes it in some respects comparable to the founding of the Bretton Woods system.' (Artis, 2002: 155).

The SGP consists of a preventive arm, which is intended to strengthen the surveillance of budgetary positions and the surveillance and co-ordination of economic policies, and a dissuasive arm, which is intended to accelerate and clarify the excessive deficit procedure of the Treaty.<sup>1</sup>

Coming into force in 1998, six years after the Maastricht Treaty that had laid the constitutional foundations of EMU, the SGP was intended by its framers to strengthen the principles of budgetary discipline formulated in the Treaty so as to ensure that Member States would continue to abide by them, not just during the run-up to joining the single currency but beyond.

The approach chosen by the framers of the SGP was two-pronged:

*First*, the 3 per cent of GDP reference value for triggering the excessive deficit procedure should be treated as much as possible as a 'hard ceiling', the breaking of which would put in motion 'a quasi-automatic mechanism' (Stark, 2001) for imposing sanctions, with escape clauses defined as narrowly as possible and legally binding deadlines for taking

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<sup>(\*)</sup> An early version of this paper was presented at the conference 'The Stability and Growth Pact: Experiences and Future Aspects', ECSA and Europinsitut, Vienna, March 2005. The views in this paper are the author's alone and should not be attributed to the European Commission or the Directorate General for Economic and Financial Affairs.

<sup>1</sup> A detailed account of the legal aspects of the SGP is provided in Cabral (2001).

decisions imposed. These features strengthened the role of the 3% deficit threshold, which had been introduced relatively late in the negotiations for the Maastricht Treaty and then hedged about with qualifications. As Bini Smaghi (2004: 2) recalls, the report by the Chairman of the Monetary Committee on “The State of the Committee’s Discussion on Excessive Deficits in EMU”, dated 25 June 1991, stated that: “This procedure must address deficits representing gross errors of budgetary policy which jeopardize the stability of the Union or of a member state. It must be designed to identify such deficits and enforce their reduction. By its nature the initiation of this special procedure should not be a frequent event in full EMU”. In the same vein, an expert closely involved on the Commission side in the Maastricht Treaty negotiations sums up the prevailing view of the excessive deficit procedure before the adoption of the Pact (Italianer, 1993: 86) "... it is clear that the excessive deficit procedure is not a mechanistic procedure: the criteria or the judgment of the Commission are used to start a process which, after careful consideration of all the relevant aspects, may lead to the judgment that a Member State has an excessive deficit. Given the fact that, according to economic theory, an excessive deficit is difficult to define on the basis of strict criteria alone, this seems a balanced compromise." Ensuring that breaches of the deficit ceiling would be a rare event would be the purpose of the so-called dissuasive arm of the SGP, which fleshes out the excessive deficit procedure foreseen by the Treaty (Art. 104), in particular by defining the exceptionality condition allowing a temporary breach of the 3 per cent of GDP threshold<sup>2</sup>, specifying the timetable for the correction of the excessive deficit and the adoption of decisions by the Council until the eventual imposition of sanctions for non-compliance, and the scale of such sanctions.

*Second*, Member States should commit themselves to a "medium-term budgetary objective of close-to-balance or in surplus", thereby providing on average a safety margin of 3 percentage points of GDP against breaching the 3 per cent deficit ceiling, enough to ensure that movements in the budgetary balance in response to cyclical fluctuations would leave the deficit under 3 per cent of GDP in all cases but a few rare recession episodes. This was to be the purpose of the so-called preventive arm of the SGP, which fleshes out the surveillance economic policies provisions of the Treaty, in particular by institutionalising the annual submission by Member States and examination by the Council of stability

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<sup>2</sup> While the SGP provides a clear definition of the exceptionality and temporariness clauses, the closeness to the 3% of GDP threshold was not specified, the reason presumably being that no Member State wanted to anticipate at the time the level of the deficit which would be acceptable for qualifying for euro-area membership. Some ambiguity on how close the deficit should remain to the 3% of GDP reference value would also provide some flexibility in the definition of an excessive deficit.

programmes setting out their medium-term budgetary strategy to achieve and maintain the close-to-balance or in surplus objective, including the accompanying economic assumptions, and putting in place an early-warning mechanism for addressing recommendations in the event of a ‘significant divergence of the budgetary position from the medium-term objective, or the adjustment path towards it.’

The SGP has been the subject of heated controversy among academics and opinion-makers ever since its inception. Opponents considered it ‘a vote of no confidence by European authorities in the strength of democratic institutions in the member states’, even going beyond the conditions the IMF imposes on banana republics (De Grauwe, Financial Times, 25 July 2002); supporters saw it as ‘the price that must be paid for a common currency’, noting that ‘stability between currencies has been possible only when countries have been prepared to relinquish some national sovereignty’ (Siebert, Financial Times, 6 August 2002).

Proposals for radical changes have been put forward, even going as far as the idea of abolishing the Pact altogether. The debate on a possible reform of the SGP accelerated after 2002, prompted by the failure of key Member States to respect its basic requirements. The final trigger for reform was the stalemate following the November 2003 ECOFIN Council’s refusal to endorse the European Commission’s recommendations to step up the excessive deficit procedure vis-à-vis France and Germany. Negotiations on the reform then started with a communication by the Commission in September 2004; a political agreement was reached by the ECOFIN ministers in March 2005 and the process was eventually concluded in July 2005 with a new legislative text.

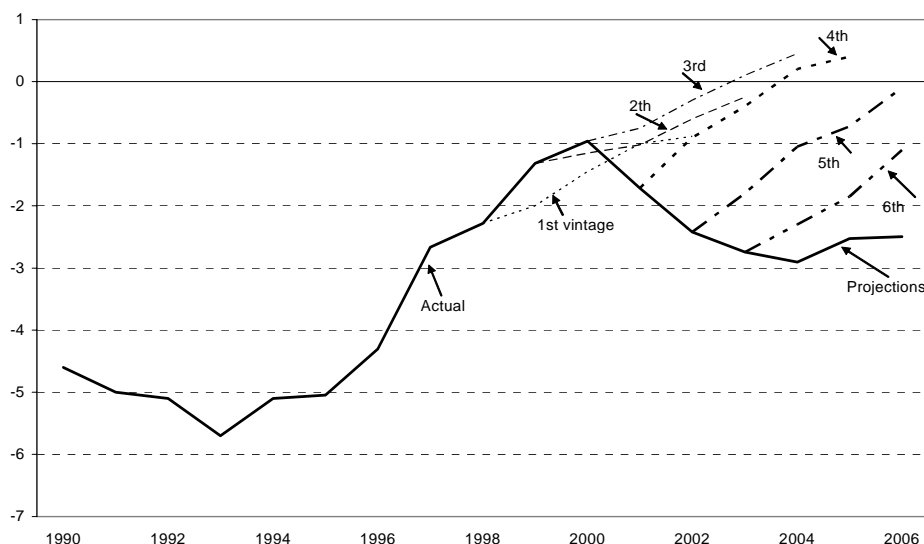
The purpose of this article is to offer an initial evaluation of the SGP reform. Section 2 reviews the main fiscal policy developments in the early years of EMU which were at the basis of the crisis of the SGP ‘mark I’. Section 3 describes the reformed SGP and an assessment of its main features. Section 4 presents some reflections on the political economy of the EU rules, comparing the new SGP with the Maastricht Treaty and the SGP ‘mark I’. The final section concludes.

## ***2. Fiscal policy in the early years of EMU: a snapshot***

The imposition of the Maastricht budgetary targets at the beginning of the 1990s undeniably launched a genuine process of consolidation. In most countries budget deficits declined substantially after 1993, the year which marked the entry into force of the

Maastricht Treaty and in which the euro area registered the historically high deficit ratio of 5.5% of GDP. Aided also by lower interest rates thanks to reduced risk premia, the cyclically adjusted balance improved by 4.5 percentage points in the euro area between 1993 and 1999 (Figure 1), and was brought back below the 3% of GDP threshold in all Member States except Greece by 1997.

Fig. 1 – Cyclically adjusted balance of the euro area



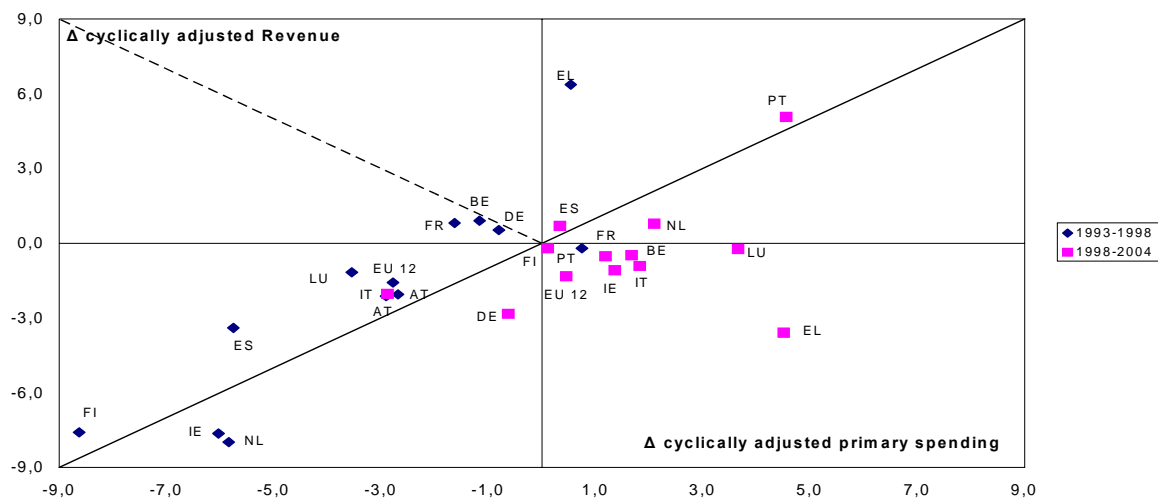
Source: European Commission

Some countries achieved spectacular turnarounds in fiscal performance. Italy managed to reduce its budget deficit by 7 percentage points of GDP between 1993 and 2000. Finland quickly regained control of its public finances after the recession of the early 1990s, posting – like Luxembourg – a surplus above 5% of GDP in 2000. In contrast, Germany and France, traditionally bastions of fiscal prudence, struggled to reduce budget deficits and keep control of public debt, fuelled in Germany by the costs of unification and in France by subdued economic performance in the first part of the period. In these countries public debt actually increased – though from a starting level below the 60% of GDP reference value.

The composition of the fiscal consolidation is shown in Fig. 2, which decomposes the discretionary fiscal policy changes into changes in total revenue and changes in primary expenditure. The diagonal from top right to bottom left indicates the direction of the budgetary adjustment: the area above it marks an improvement in the cyclically adjusted primary balance, while the area below it indicates a structural deterioration. The diagonal

from top left to bottom right marks the composition of the adjustment between expenditure changes and revenue changes.

Fig. 2 – Composition of the adjustment: 1993-1998 vs 1998-2004



Source: European Commission

In the run-up to EMU practically all countries lie above the top right–bottom left diagonal, meaning that their cyclically adjusted primary balance improved during the period. Moreover, most of them pursued an expenditure-based retrenchment and several countries combined discretionary cuts in spending with a reduction in tax revenue, thus reducing the overall size of the public sector. Therefore, the composition of budgetary consolidation appears to have been of ‘good quality’, according to the criteria identified in the literature<sup>3</sup>.

While the retrenchment in the run-up to EMU is commonly considered a success, the SGP, which was supposed to consolidate Maastricht’s achievements, has fallen short of its framers’ expectations. At close to 3 per cent of GDP, the cyclically adjusted deficit of the euro-area members in the aggregate remains as distant from the close-to-balance objective as it ever has since the launch of EMU.

As shown in Fig. 1 above, the cyclically adjusted balance for the euro area as a whole has progressively deteriorated in the years since 2000, falling well short of the commitments enshrined in the successive Stability Programme updates. The turnaround in both direction and composition of discretionary fiscal policy is confirmed by Figure 2, which shows that that the structural primary balances has deteriorated in most countries since the end of the

<sup>3</sup> See, i.a. Alesina and Perotti (1996) and Perotti (1999).

1990s: tax revenue has been reduced, while primary expenditure has started to climb again.

This analysis shows that the *de facto* suspension of the excessive deficit procedure in the cases of Germany and France after November 2003 (see below), which could have meant the amputation of the dissuasive arm of the Pact, had been preceded by a progressive loss of credibility of the preventive arm, as evidenced by persistent negative gaps between fiscal projections and the outcomes of successive rounds of stability programmes. However, the three largest countries in the euro appear largely to blame for this credibility gap, as their fiscal projections can be shown to suffer a significant tendency to under-predict actual deficits<sup>4</sup>. The small countries, by contrast, have managed as a group to achieve and maintain an underlying balance of their fiscal positions, something that has proved elusive for large countries (Buti and Pench, 2004).

In sum, although the Maastricht process brought the unprecedented increase in non-war debt of the previous two decades to a halt, the SGP has apparently failed to eradicate the underlying – and ultimately unsustainable – deficit bias of fiscal policies. This bias manifests itself particularly through the continuation of the tendency to run expansionary policies or to fail to consolidate in good times, as can be seen from the deterioration of cyclically adjusted balances in the last upswing.

### **3. The reform of the SGP<sup>5</sup>**

#### **3.1 A new Pact**

The failure of the SGP ‘mark I’ is epitomised by the repeated breaches of the 3 per cent of GDP deficit ceiling by individual Member States. Since 2002 six out of the twelve members of the euro area have been subject to the excessive deficit procedure; the early-warning mechanism has been invoked in four cases. Even more damaging to the credibility of the Pact than the frequency of the violations of the ban on excessive deficits has been the perceived disavowal of the original framework, and more specifically its enforcement mechanism, by key Member States. Already detectable in the apparent unwillingness of the Council to let the early-warning mechanism to run its normal course

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<sup>4</sup> As shown in Buti and van den Noord (2004a), producing over-optimistic forecasts is particularly tempting in electoral periods as a way of increasing the room for manoeuvre of discretionary fiscal policy. See Von Hagen, Hallerberg and Strauch (2004) and Larch and Salto (2005) for a more detailed discussion of this topic.

<sup>5</sup> This section largely draws on Buti et al. (2005). See also the Postscript in Buti and Franco (2005).



in the cases of Germany and Portugal in February 2002, the crisis of the enforcement mechanism of the Pact became manifest in November 2003 with the *de facto* suspension of the excessive deficit procedures initiated against Germany and France following the Council's failure to endorse Commission recommendations that the procedures be stepped up in accordance with the Pact's result-based approach to compliance.

While the debate in academic circles showed the depth of the divisions among economists, a certain consensus gradually emerged in the course of 2004 among the main policy players as to what changes were needed to the EMU fiscal framework. It was recognised that EMU needed numerical fiscal rules (since financial market discipline and national procedures were not deemed sufficient to ensure budgetary discipline) and that any radical changes to the rules introduced in 1992 (Maastricht Treaty) and 1997 (SGP) would be highly problematic. What Buti et al. (2003) called "internal adjustment" of the existing framework rather than a radical overhaul of the rules came to be regarded as the only feasible way forward. It was also acknowledged that complementary measures at the national level (such as better budgetary procedures and independent fiscal councils) would be highly desirable. The common menu of internal reforms included action to improve fiscal policy in good times, more consideration of public debt and long-term sustainability in assessing Member States' budgetary positions, a greater focus on cyclical developments and more transparency in fiscal data. Other aspects were more controversial: these included changes to the excessive deficit procedure and a stronger role for the Commission as enforcing agency.

The risks involved in embarking on a reform process under the pressure of unfavourable fiscal developments were also highlighted in the debate: the credibility of the framework itself could be endangered and the reform process could prove very long and uncertain. It was also noted that if the problem was primarily one of adherence to the rules, the priority should be to ensure rigorous implementation of the existing rules rather than to change them. At the same time, it was widely recognised that simply attempting to apply the existing rules after the watershed of November 2003 was not a viable option. Re-establishing a sense of ownership of the fiscal rules by all parties would be the precondition for their effective enforcement.

At the request of the European Council, in September 2004 the Commission issued a Communication suggesting a number of further changes to the Pact which, while preserving its overall architecture, aimed at avoiding pro-cyclical policies, especially in

good times; better defined the medium-term objective by taking into account country-specific circumstances and reforms; gave greater prominence to the debt criterion; modified the implementation of the excessive deficit procedure, in particular by allowing more time to correct an excessive deficit under certain circumstances; and improved governance and enforcement (European Commission, 2004).

After a difficult and at times heated debate, an agreement was reached at the ECOFIN Council of March 2005. The guidelines of the reform were set out in a report which envisaged changes to both the preventive and corrective arms of the Pact (Council, 2005).<sup>6</sup>

On the preventive side (i.e. the medium-term targets and the adjustment path towards them), medium-term budgetary objectives (MTO) are now to be somewhat differentiated from one country to another on the basis of debt ratios and potential growth rates. Targets will be specified in structural terms, i.e. cyclically adjusted and net of the effects of temporary measures, and will range between a deficit of 1% of GDP and a small surplus. The latter will apply to high-debt, slow-growth countries. Implicit liabilities will also be taken into account in the future, once further technical analysis allows the Council to agree on criteria and methodological aspects. Major structural reforms with long-term fiscal benefits will be taken into consideration both when defining the adjustment path towards the medium-term objective and when considering temporary deviations from the target. A more detailed set of provisions also governs the path towards the medium-term objectives, though a minimum annual adjustment of 0.5% of GDP must be ensured.

On the corrective side (i.e. the application of the excessive deficit procedure), a modification was introduced in the definition of the “exceptional cyclical circumstances” which may justify the reference value for the deficit being exceeded: a breach of the threshold will now be considered exceptional if it results from a negative growth rate or an accumulated loss of output during a protracted period of very low growth relative to potential growth. When evaluating deficits exceeding the 3% limit, the Commission will take into account a number of factors ranging from cyclical conditions, through the implementation of the Lisbon agenda and policies to foster R&D and innovation, debt sustainability, the overall quality of public finances and financial contributions to international solidarity to fiscal burdens related to European unification. However, any excess over the 3% deficit threshold should remain limited and temporary. The

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<sup>6</sup> These changes were subsequently translated into legislative amendments of the SGP regulations in July 2005. For a detailed presentation of the new Pact, see European Commission (2005).

implementation of pension reforms establishing a compulsory funded pillar will also be taken into consideration, especially when assessing whether an excessive deficit has been corrected.

While confirming that, as a rule, the deadline for the correction of an excessive deficit will remain the year after it is identified, the Council decided that the initial deadline could be set one year later if there were special circumstances, and could be revised at a later stage if unexpected adverse economic events with major unfavourable budgetary effects occurred.

The Council called for a stronger weight to be given to public debt, but was not able to agree on a quantification of the minimum debt reduction for countries with very high debt ratios, as suggested by the Commission.

The Council also outlined a number of steps to improve the governance of EU rules. It suggested closer co-operation between Member States, the Commission and the Council in the implementation of the Pact. It indicated the need to develop national budgetary rules and ensure that national parliaments are closely involved in the process. Finally, it called for reliable macroeconomic forecasts and budgetary statistics.

### **3.2 An evaluation of the reform**

These changes got a mainly sceptical reception. Some commentators argued that, given the host of exceptions to the 3% rule and the greater discretion left to the Council, the Pact was, *de facto*, dead (Buiters, 2005, Calmfors, 2005). Even those traditionally critical of the old SGP, while appreciating the better balance between fiscal discipline and flexibility, viewed the reformed Pact as excessively prone to opportunistic interpretations and as having failed to tackle the root causes of fiscal imbalances (Coeré and Pisani-Ferry, 2005).

In reviewing the debate on the SGP, Buti et al. (2005) highlight four critical issues that any effective reform of the Pact should tackle: (a) overcoming excessive uniformity, (b) improving transparency, (c) correcting pro-cyclicality, and (d) strengthening enforcement.

Table 1 provides a qualitative assessment of the main changes in the preventive and corrective arms of the SGP from these four perspectives. In the rest of this section, we provide an initial assessment of the 2005 reform and give some indications on where further progress is needed to ensure the effectiveness of the new rules.

Table 1 Desirable improvement of the SGP: how the new Pact scores

2005 SGP REFORM	Overcoming excessive uniformity	Improving transparency	Correcting pro-cyclicality	Strengthening enforcement
<b>I. <u>Governance</u></b>				
Stability programme for the legislature		(+)		
Involvement of national Parliament				(+)
Reliable forecasts		(+)		(+)
Better statistical governance		+		+
<b>II. <u>Preventive arm</u></b>				
Medium-term objectives	++	-		
Adjustment path	+		+	
Structural reforms	+	-		-
<b>III. <u>Corrective arm</u></b>				
Exceptional circumstances	+		+	
'All other relevant factors'	+	--		--
Systemic pension reforms	+			-
Debt and sustainability	+	-	+	
Repeatability of steps	+	-	+	-
<b>Overall assessment</b>	+	-/+	+	-/+

Legend: ++ strong improvement, + improvement, - deterioration, -- strong deterioration. (+) improvement if effectively implemented at national level.

**Overcoming excessive uniformity** – The new SGP has introduced some elements of country-specificity in both the preventive and the corrective arm of the Pact. The close-to-balance rule of the original SGP, interpreted as broadly balanced budgets in cyclically adjusted terms, treated equally countries with different levels of public debt, implicit and contingent liabilities, and public investment needs.

In the early years of EMU, the only dimension on which countries were differentiated was the variability of the cyclical component of the budget balance: economies subject to higher business cycle volatility and having larger automatic stabilisers require a larger cyclical safety margin in order to avoid breaching the 3% of GDP deficit ceiling under normal cyclical circumstances (Artis and Buti, 2000). In the new Pact, the articulation of the MTO has been extended to other dimensions, such as the financial fragility of the country, as embodied in the stock of public debt, and – in the future – the threat to long-term sustainability represented by the implicit liabilities of pension systems and the capacity of countries to ‘grow out of their debt’, measured by taking into account their potential growth (and therefore structural reforms which are intended to boost it).

The Council has taken a cautious approach by stipulating that, in order to safeguard the 3% deficit ceiling, the medium-term target should never exceed a deficit of 1% of GDP. This implies that countries with a relatively low stock of debt and estimated implicit liabilities will be allowed to have cyclically adjusted budget deficits of up to 1% of GDP. This solution is consistent, in most cases, with a prudent version of the golden rule<sup>7</sup>. In the case of structural reforms entailing frontloaded costs, deviations from the MTO are allowed, but only under strictly defined conditions. The debt ratios in high debt countries and in countries with expected rising expenditure levels should decline fast, helping to offset the burden of ageing in the future, while in the other countries deficit levels will ensure the maintenance of a small public debt. The solution should strengthen the political incentives to reduce the current and implicit debt at a faster pace.

In order to avoid moral hazard, commonly agreed estimates of implicit liabilities in EU countries will have to be computed, following the experience of the Economic

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<sup>7</sup>As pointed out above, in the case of public investment, the right concept is that of net investment (hence taking into account amortisation).

Policy Committee's estimates of age-related public spending (EPC, 2003). The use of long-term projections in the EU fiscal framework should be conditional on progress concerning the comparability, transparency and independence of the projections. A variety of sustainability indicators could be used: tax-gaps, government net worth, and generational accounting. Since each indicator requires some arbitrary choices, it will be necessary to predefine the relevant assumptions and parameters and agree on a common set of indicators.

The new SGP also introduces elements of country-specificity in the corrective arm of the Pact. As argued below, whilst such changes may reduce excessive uniformity of the rules, they may in some instances increase their complexity, with negative implications for transparency and enforcement.

**Improving transparency** - Transparency has several dimensions: it includes accounting conventions, forecasting exercises and reporting practices (Kopits and Symansky, 1998). Two aspects are particularly important. (i) Fiscal indicators providing a comprehensive view concerning current and perspective fiscal accounts and compliance with the rules should be available to monitoring institutions, the general public and financial markets. (ii) The design of the rules should allow for an unambiguous assessment of compliance. This calls for simple, well-defined rules.

Regarding the first aspect, the EU fiscal framework has been widely criticised for a lack of transparency,<sup>8</sup> manifested in a number of ways. First, the deficit indicator as defined by ESA-95 does not provide a full picture of countries' public finance imbalances. Second, the debt indicator (gross financial debt at face value) allows targets to be achieved via operations which do not improve fiscal sustainability, and tends to underestimate overall outstanding liabilities. Third, under the current system of national accounts, monitoring is hampered by delays in data provision and allows some manipulation of statistics with the result that the whistle is often blown far too late or only when the true data eventually surface. And lastly, the forecasts underlying stability programmes have frequently turned out to be over-optimistic.

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<sup>8</sup> See Balassone Franco and Zotteri (2005), Buti, Nogueira Martins and Turrini (2006), Koen and van den Noord (2005) and von Hagen and Wolff (2004).

The new SGP includes potentially important provisions leading to improved transparency, but also elements which work in the opposite direction.

In recent years, in order to meet the short-term targets, countries have frequently adopted one-off, cash-raising measures instead of making the necessary structural adjustment. The decision that compliance with the medium-term target as well as with the minimum annual adjustment of 0.5% of GDP is to be assessed in *structural* terms, by netting out the estimated effect of the cycle and one-off measures, will lead to improved transparency. In order to implement this, an agreed definition of one-off measures could complement the existing agreement on how to compute cyclically adjusted balances. However, given the current legislation and accounting conventions, the 3% rule has not been modified. Hence, in practice, one-off measures can still be used at the margin to avoid an excessive deficit. As to the abrogation of an excessive deficit, it will be important to focus on the *durability* of the adjustment, thereby reducing the incentives to use one-off measures to temporarily bring the deficit below the reference value without correcting the underlying imbalances.

As to public debt, the application of the fiscal rules will continue to focus on its definition in *gross* terms. However, this overlooks the fact that government assets can be sold to repay the debt and that there are non-financial liabilities. It is preferable to use both a gross and a net debt definition. On the basis of an agreed, transparent framework, governments could be required to provide estimates of off-budget liabilities, their net asset position and long-term budgetary trends.

The availability of high-quality statistics and timely fiscal indicators is still an issue. The problem of early detection of deviations from targets was vividly exposed in the case of Portugal in 2001. Even more serious has been the case of Greece, which in 2004 turned out to have had a deficit in excess of 3% of GDP since 1997. In Greece's case, but also in other countries, the yearly increase in public debt has frequently exceeded the deficit level as below-the-line operations have systematically contributed to debt growth.

The new Pact acknowledges the importance of high-quality, timely and reliable fiscal statistics and pledges to ensure the independence, integrity and accountability

of both national statistical offices and Eurostat.<sup>9</sup> The availability of better statistics should be complemented by a more comprehensive surveillance of fiscal variables. One way forward would be to resurrect, in parallel with national accounts definitions, regular monitoring of cash flows. National authorities could be required to indicate *ex ante* cash figures broadly consistent with the ESA95 balance. In parallel, changes in the debt level (net of the effects of exchange rate changes and privatisation proceeds) could be closely monitored: if a significant departure from target is detected in financial flows, it would be up to national authorities to explain the difference.<sup>10</sup>

The overly optimistic forecasts that are common in some Member States can translate into higher-than-projected deficits, since government revenues quickly respond to changes in potential output whereas adjustments on the expenditure side normally require a lengthy process of political decision-making. The new Pact indicates that budgetary projections should be based on realistic, even cautious, macroeconomic forecasts. The European Commission (2004) proposed that stability programmes should be based on macroeconomic assumptions provided by the Commission. The Council decided that countries are still free to use their own assumptions, but that they give detailed explanations of any divergences from the Commission forecasts.<sup>11</sup>

While the above changes are a step towards improving the quality and availability of fiscal indicators, others are likely to negatively affect the second aspect of transparency mentioned above, namely the possibility to easily assess compliance with the rules.

As to the corrective part of the Pact, the most notable amendment is the specification of so-called ‘other relevant factors’ in the assessment of whether a deficit in excess of 3% of GDP can be considered ‘excessive’ in the sense of the Treaty. Such factors

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<sup>9</sup> On the importance of a reliable statistical framework for the application of EU fiscal rules, see Balassone, Franco and Zotteri (2003).

<sup>10</sup> As initially proposed by the Commission, in the cases of application of the excessive deficit procedure to Greece, Portugal and Italy in 2005, the recommendation on issued by the Council included a mention on avoiding reliance on below-the-line operations.

<sup>11</sup> The case for independent forecasts is advocated by Jonung and Larch (2004).



– ranging from the implementation of the Lisbon agenda and policies to foster R&D and innovation, through the overall quality of public finances and financial contributions to international solidarity, to fiscal burdens related to European unification – may give countries easy escape routes in the event of deficits in excess of the reference value. While there is an important safeguard in the provision that any excess over the 3% deficit threshold should remain limited and temporary, such a long list of relevant factors runs the risk of blurring the assessment.

The preventive part of the SGP has also become more complex. The medium-term objectives are no longer defined *ex ante*, but are set by countries themselves in their programmes on the basis of commonly agreed criteria that might evolve over time.

**Correcting pro-cyclicality** – It is widely recognised that the original SGP did not provide sufficient incentives for countries to run prudent fiscal policies in good times, with the result that their room for manoeuvre was curtailed in bad times. The new agreement explicitly aims to correct pro-cyclicality by emphasising the importance of reliable macroeconomic forecasts, the commitment to stepping up consolidation in good times, relaxing the “exceptionality clause”, making the timing of the correction of the excessive deficit a function of the prevailing cyclical conditions and foreseeing the guarded possibility to repeat steps of the procedure in the event of adverse shocks.

While these changes go in the right direction, it remains to be seen whether they go far enough in terms of sticks and carrots.

One possible way of stepping up peer pressure would be to use the early warning procedure of the SGP, not only in bad times when the deficit approaches the 3% ceiling, but also in good times when a significant divergence from structural targets is detected. The idea of an early warning procedure independent of the immediate danger of an excessive deficit was considered by the European Commission (2004). However, the new SGP, while providing for the possibility for the Commission to issue “policy advice” in this regard, did not accept the proposal.

Buti et al. (2003) and Sapir et al. (2004) have argued that the introduction of rainy-day funds may improve the incentives for prudent fiscal behaviour in good times. These funds, which would be used in times of recession and replenished in upturns,

might increase the incentive for governments not to waste the surpluses in good times and increase the room for manoeuvre in bad times. However, establishing them would require a review of the current ESA accounting rules for computing budgetary statistics, so such a move, although interesting, is not unproblematic.<sup>12</sup>

**Strengthening enforcement** – A legitimate criticism of the Treaty and the old SGP is that enforcement is partisan: national authorities are supposed to apply the rules to themselves, and therefore have strong incentives for collusion and horse-trading. As indicated in table 1 and as is the case with transparency, the new Pact includes both some provisions which will strengthen enforcement and others which are likely to weaken it.

As Buti et al. (2003) point out, enforcement is particularly problematic in the case of supranational fiscal rules applying to sovereign countries. Enhancing national ownership of the rules would mean that there was a better chance of them becoming self-enforcing<sup>13</sup>. In parallel, the Commission's role in enforcing the SGP should be strengthened.

On the first count (national ownership), the new provisions concerning governance – notably the involvement of national parliaments – go in the right direction, but are too modest. In particular, the suggestion to establish independent monitoring bodies at national level, which was mentioned in the initial proposals by the Commission (European Commission, 2004), was not accepted. On the second count (a stronger role for the Commission), the new Pact does not introduce any significant change either in voting or in the procedural arrangements. Evidently, the Council was not prepared to strengthen the authority of the Commission in the interest of the credibility of EU fiscal rules. On the contrary, there is a risk that provisions such as the considerations of 'other relevant factors' could work against effective enforcement of the rules by reducing transparency and increasing the possibility of collusion in the Council.

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<sup>12</sup> Alternatively, the Treaty protocol could be revised, mentioning that the 3% reference value refers to budget balances net of accumulation of assets in the rainy-day fund. However, if the fund were depleted after protracted deficits, the budget balance figure used in the SGP would quickly worsen, leading to difficulties in the implementation of the SGP.

<sup>13</sup> As Buti and Pench (2004) argue, this is particularly important in the case of large euro-area countries where the threat of external sanctions is less effective.

#### **4. A political economy view: renewed ownership or green light for collusion?**

Experience clearly shows that successful implementation of the new Pact will depend on political will. In order to assess whether the reformed rules incorporate adequate incentives for compliance, it is useful to identify what went wrong with the original SGP compared to Maastricht from the political economy standpoint. Table 2 sketches out a number of features which have been considered the basis of the success of the Maastricht process<sup>14</sup>. While the SGP ‘mark I’ can be easily assessed against those criteria, it is too early to do the same for the reformed Pact’. Therefore, the table presents two alternative prospective readings: an opportunistic ‘collusive’ deal and ‘genuine’ adherence to the revamped rules.

Table 2 – The old and the new Stability Pact: two readings

	<b>Old SGP</b>	<b>New SGP: Collusion</b>	<b>New SGP: Genuine</b>
1. Public visibility	High but fading	On the way to oblivion	Medium
2. Clear incentives	Blurred	Easier to get away with	Better rationale
3. Political ownership	Small MS	High deficit MS: DE+FR+IT	Germany and virtuous MS
4. Constraining calendar	CTB a moving target	MTO de facto never	MTO by the end of Stability programme
5. Collegial culture	Acrimony prevailed	Mutual back-scratching	New collegiality based on trust

**Public visibility** – With the Maastricht convergence criteria, the objective of meeting them became the centrepiece of government strategies in many EU countries. Public visibility was greatly facilitated by the simplicity of the 3% of GDP deficit criterion, which provided a clear signpost for economic policies regardless of the political colour of the government, especially in countries which entered the 1990s with very high deficits and looming unsustainability threats. The simplicity and the (largely) unambiguous definition of the fiscal requirements – especially that concerning the budget deficit – allowed the European Commission to effectively monitor them as an external agent entrusted by all Member States with the correct interpretation and implementation of the Treaty criteria. High visibility, together with easy monitoring, was also one of the reasons for preferring numerical targets

<sup>14</sup> See Buti and Giudice (2002) and Buti and van den Noord (2004b).

over national procedural rules. The close-to-balance-or-in-surplus rule of the SGP enjoyed lower visibility than a simple deficit ceiling would have. The fact that, in the reformed Pact, the MTOs have to be set by national authorities (albeit within the range agreed upon by the Council) gives a better chance of renewed visibility – assuming a genuine implementation of the new rules. By contrast, a collusive approach would relegate the Pact to the back burner and, after an initial period of renewed interest, it would be likely to fade into oblivion.

**Clear structure of incentives** – The rewards and penalties linked with the Maastricht public finance requirements were very clearly laid out. Politically, meeting the convergence criteria would allow budgetary laggards to join the virtuous countries in the new policy regime, while failing to comply carried the penalty of exclusion from the euro area. This was considered too harsh a political sanction, especially for countries traditionally at the forefront of the process of European integration. Market incentives were therefore also crucial, notably because countries with high deficits and debt levels adopting a credible adjustment programme could enjoy a less costly and faster reduction of risk-premia in interest rates, which would help lower public finance imbalances. With the move to a single currency, the structure of incentives changed: the market incentives were reduced with the convergence of interest rates and the carrot of entry was eaten, while the stick of exclusion was replaced by the threat of sanctions under the SGP that might only materialise at a late stage, if at all. The experience of the early years of EMU showed that the Council was not prepared to use the ‘nuclear option’ of pecuniary sanctions, especially vis-à-vis large countries. The new Pact offers easier ways out, for instance by allowing repetition of the various steps of the EDP procedure. However, if applied genuinely, this stronger economic rationale may help justify increasing peer pressure on fiscal delinquents.

**Political ownership** – The whole debate on the fiscal requirements of EMU reflected Germany’s concern with fiscal discipline: both the Maastricht fiscal criteria and the SGP clearly bear Germany’s fingerprints. Strong macroeconomic stability came to be regarded as an essential precondition for Germany to agree to merge its monetary sovereignty into a single currency. The political ownership of the SGP shifted towards smaller countries with structural surpluses which, although

numerous, have a relatively small weight in the euro area. This was sufficient to keep the Pact alive, but weakened the enforceability of the rules, especially vis-à-vis large countries. Germany holds again the key to a rigorous implementation of the new rules. Renewed political ownership by Germany requires it to accept a strict application of the rules to itself, and thus to lead by example. If it does not do so, high deficit countries will take over, paying lip service to the EU rules but disregarding them in practice. Resistance by virtuous small Member States would in that case eventually be swamped in a collusive deal.

**Constraining calendar** – The Treaty set very clear deadlines for moving to the final stage of EMU. Countries willing to join with the first wave had no choice but to make the required consolidation effort to meet the convergence requirements. The SGP set very clear, short deadlines between the various steps of the procedure, but the 2003 November crisis over stepping up the EDP for France and Germany led to a stalemate. Moreover, the creation of sufficient margins under the 3% deficit ceiling was not linked to a specified calendar and, as discussed above, close-to-balance positions became a moving target. This would be the fate of the MTO if the collusive option under the new Pact were to prevail. But if the new rules are applied in earnest, the provision for non-EDP countries to achieve their MTO by the end of the Stability Programme period may hold.

**Collegial culture** – During the run-up to EMU, the convergence process facilitated the progressive building of a collegial culture of stability through personal contact amongst policy-makers and national and EU officials. This new climate facilitated peer pressure between national authorities and enhanced the role and authority of the European institutions. In the implementation of the SGP, however, this climate of mutual trust was replaced by acrimony between the Council and the Commission (which culminated in the Court appeal after the 2003 November crisis), and between large and small countries. Under the reformed Pact, if collusion prevails, the more complex setting would favour mutual back-scratching by fiscal sinners ('I help you now, you help me later'), whereas a genuine application of the new rules would favour the emergence of a new collegial atmosphere based on trust.

What are the chances that the new SGP will be applied in a rigorous manner? According to most academics and policy commentators – even those fiercely critical

of the old Pact – the new rules bear the imprint of collusion as a birthmark. However, while a certain degree of scepticism may be justified, we should not write off the Stability Pact ‘mark II’ too quickly. At EU level, the loss of reputation that its failure would entail for the ECOFIN Council and, especially, the Eurogroup, not to mention the Commission, would be enormous. At national level, the key to its success is held by large countries – first and foremost Germany. We will not have to wait for long before the jury comes back with its verdict.

## **5. Conclusions**

The EU fiscal policy framework aims to balance fiscal discipline and fiscal stabilisation in a context in which countries ultimately remain responsible for national fiscal policy.

Clearly, the Stability Pact ‘mark I’ had a number of drawbacks – particularly its asymmetric incentives and lack of a long-term view. The reformed Pact goes some way towards correcting such problems while retaining the original architecture.

Some innovations allow greater flexibility in dealing with special circumstances and country-specific problems, while retaining a prudent approach to fiscal behaviour. If they are actually implemented, the steps being considered to improve fiscal transparency, enhance the quality of statistics and strengthen national budgetary institutions have the capacity reinforce the rules. On the other hand, the extended deadlines for correcting deficits and, more generally, the greater complexity of the new framework may lower the visibility of the fiscal targets and make monitoring less effective. Few changes have been introduced in the key provisions affecting enforceability of the rules.

A successful application of the new Pact will require increasing political accountability at national level. This applies to the provisions concerning governance, namely the use of reliable forecasts and the stronger role of national Parliaments. It would be a great help if independent national boards in charge of budgetary monitoring and assessment were created in all Member States. In due course, the Commission’s initial suggestion to establish a “European semester”, where the broad orientations for fiscal policy are agreed, followed by a “national

semester” where these general orientations are translated into concrete policy actions, should be resurrected in order to increase coherence and visibility.

But, in the end, the major weakness of the old rules was poor enforcement mechanisms. Will the new rules be more effectively enforced? The fact that in the new Pact there is a greater margin for discretion but no independent enforcer may increase the incentives for collusion by the Council in subverting the implementation of the rules. If so, the lack of enforcement will persist or even be aggravated. However, as the new Pact has a stronger economic rationale and may improve national ownership and fiscal transparency, there may be a better chance of it becoming self-enforcing.

While the reformed SGP has been greeted with scepticism in many academic and policy circles, it would be wrong to assume that it is bound to become irrelevant. First, the reasons why fiscal rules were adopted in a monetary union of many sovereign countries in the first place are still valid. The future enlargement of the euro area to Central and Eastern European countries actually strengthens the need for a common fiscal framework (Orbán, G. and G. Szapàry, 2004). Second, no viable alternative to a credible supranational rule has emerged from the debate on the reform of the Pact, since all the other potential solutions have foundered on serious criticism of one kind or another. Third, many countries will continue to need an external anchor to ensure sound fiscal policies leading to a reduction in debt levels also for purely domestic reasons – particularly the demographic shock which lies around the corner. Finally, it is likely that, as soon as serious imbalances emerge in some countries, threatening the stability of the euro area, the other euro-area members will step up the pressure for rigorous implementation of the rules.

Whether and when a call for stronger fiscal discipline will arise depends on politics, the key factor being renewed ownership of the rules. In the end, the new rules can be rigorously applied only if they are backed by key players and fully integrated in their national policy framework.

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