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Lars Calmfors

What Remains of the Stability Pact and What Next?

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FOREWORD

Earlier this year, the stability pact of the EU was reformed. The revision followed upon violations of the EU fiscal rules by several countries and the breakdown of the pact's enforcement mechanism. A key question is what contribution can the revised stability pact make towards upholding fiscal discipline in the future.

Professor Lars Calmfors summarises in this report the main EU fiscal rules, reviews the way the rules have been applied in the past, and surveys the recent debate. The report also provides a thorough review and evaluation of the reform of the stability pact. The study takes a pessimistic view of the future of the stability pact and therefore suggests alternative ways of promoting fiscal discipline in the EU: enhanced co-operation in a smaller group of EU countries and stronger national fiscal policy institutions.

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By publishing this report, SIEPS hopes to contribute to the European discussion on the fiscal framework.

Stockholm, November 2005

Annika Ström Melin
Director

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1 INTRODUCTION AND SUMMARY

This essay reviews and analyses the reform of the stability pact earlier this year (2005). The revisions followed upon violations of the EU fiscal rules by several countries, notably France, Germany and Greece, and the breakdown of the pact's enforcement mechanism. The question is what contribution can the revised stability pact make towards upholding fiscal discipline in the future.

The changes in the pact imply a larger tolerance of budget deficits. Deficits above three per cent of GDP are permitted in more cases than before and the time limits for correcting excessive deficits become longer. It is very uncertain whether the sanction system with deposits and fines for countries with excessive deficits will ever be used. And even if it is used, the revised framework would seem to permit budget deficits above three per cent of GDP for six to nine years before fines are imposed. Overall the revisions in the stability pact represent a large departure from a rules-based system, reverting to a system of discretionary policy making, where unconstrained policy makers are free at any point of time to choose the policy they find the best. However, the largest problem is not the formal changes to the stability pact that have been undertaken. It is the credibility loss from the demonstration that the EU fiscal rules are endogenous and likely to be adjusted in response to violations.

The reform of the stability pact represents a serious weakening of the constraints on large budget deficits in EU countries. This is very problematic, as modern democracies seem to exhibit a *government deficit bias*. There are several reasons for this. Fiscal policy may become too expansionary before elections (political business cycles). Various interest groups are lobbying in favour of expenditure increases or tax decreases benefiting the own group without regard for the economy-wide effects (the common-pool problem). Political parties that risk losing the next election may want to favour their own constituency while still in power (strategic considerations). A government may be tempted to reach short-term policy goals even if this implies long-term costs (the time inconsistency problem).

The deficit bias may be particularly strong in the euro area, since a common currency implies that part of the costs, in terms of effects on interest and exchange rates as well as inflation, may be shifted on to other countries. Hence, the weakening of the stability pact paves the way for a loosening in fiscal discipline, in much the same way as occurred in the 1980s and early 1990s in many European countries. There is a risk of contagious effects, where deficits spread from one country to another. The con-

sequences will be an undesirable distortion of consumption over time and among generations, higher interest rates and dramatic fiscal consolidation efforts when government debt problems are ultimately addressed. If growing government debt were to cause an inflationary process, one cannot rule out the risk that the whole EMU project might be jeopardised.

The exact damage from the reform of the stability pact will depend on how the revised rules are applied over the next few years. The current large deficits in especially France, Germany, Greece, Italy and Portugal will provide defining test cases. A loose interpretation of the revised rules, exploiting to a maximum degree the new exemption possibilities, will effectively kill off most of the remaining credibility of the EU fiscal framework. In the future, the three-per-cent-of-GDP deficit ceiling will then at most operate as a non-binding benchmark in the public debate. A strict interpretation of the revised rules, involving sanctions in the case of continued excessive deficits in France, Germany and Greece, could, however, establish a *precedent* and put a limit to the weakening of the stability pact. But such a development is unlikely, as the same forces that caused the breakdown of the enforcement mechanism in 2003 and the subsequent revision of the pact continue to operate.

The main problem of the earlier stability pact was not deficiencies in the economic contents of the rules but the lack of enforcement. The incentives to use the sanction system were too weak. For the revised fiscal framework to stand any chance of functioning, these incentives would have to be strengthened. One possibility would be to move decisions on sanctions from the political to the judicial sphere, that is from the Ecofin Council to the European Court of Justice. Another option would be to try to increase the probability that the Ecofin Coucil would actually use the available sanctions. This could require changes of the following type:

- A stipulation that countries with excessive deficits are not allowed to vote in the excessive deficit procedures against other countries to reduce the risks of collusive behaviour.
- A reduction in the size of initial sanctions to make them less of an "atomic bomb". This would weaken political resistance against using them.
- Complementing smaller pecuniary sanctions with non-pecuniary ones, for example a gradual loss of voting power in the Ecofin Council, to overcome the criticism that fines exacerbate the deficit problems they are supposed to mitigate.

Unfortunately, additional reforms of this type are improbable, at least in the foreseeable future. Politicians are likely to shy away from further attempts at changing the stability pact that might provoke conflicts among member states. Nor should one expect, with the present uncertainty regarding the proposed constitution, any attempts at Treaty changes, which would be required for changes in voting rules. Hence, there is a need for other options.

One possibility might be that a *group* of EU countries takes an initiative to uphold fiscal discipline by forming a *sustainability pact* with more stringent provisions than the watered-down stability pact. Such an initiative could either exploit the formal possibilities in the current EU Treaty for a limited number of member states to engage in *enhanced co-operation* or be of a more informal character, with co-ordinated changes at the national level. Possible candidates for participation could be a number of countries both inside and outside the eurozone, such as Austria, Belgium, Denmark, Estonia, Finland, the Netherlands, Spain and Sweden, which have exercised more fiscal discipline than some of the larger countries and tried to defend the earlier rules. Ireland among the old EU states and Latvia, Lithuania and Slovenia among the new ones might be other candidates, since they also have a good fiscal record.

Such a fiscal sustainability pact might contain both procedural and policy commitments. The procedural provisions could aim at remedying the current "disconnect" between policy considerations at the EU and the national level. Participating countries could commit to letting both the Commission and the (chair of the) Ecofin Council[1] make presentations before the national parliaments (of policy advice and opinions in the fiscal surveillance process as well as of reports and recommendations in the excessive deficit procedure). The countries could also commit to holding open parliamentary hearings as well as parliamentary debates on the basis of the presentations. Such commitments could be seen as a follow-up of ideas in the agreement among finance ministers on the reform of the stability pact. As regards actual policies, participants could, for example, commit to not using the extended deadlines in the reformed stability pact except in extreme situations. This would imply that excessive deficits are corrected the year after they are discovered, as was the original intention behind the stability pact. In addition, one could require that budget deficits have indeed been below three per cent of GDP, or even lower, for a certain length of time before a country is allowed to enter the sustainability pact.

[1] The Council of Ministers of the European Union is termed the Ecofin Council when it is made up of the economics and finance ministers of the member states.

Establishing enhanced co-operation regarding fiscal policy among a group of EU countries would both promote fiscal discipline in the participating countries and serve as an example for others to follow. But such enhanced co-operation could also have wider ramifications. Closer co-operation by an "unconventional" group of EU countries (a number of small countries most of which are outside what has usually been viewed as the core of the EU), could arguably contribute to the future development of the EU by providing a concrete example of *flexible integration*. The main argument against such enhanced co-operation in the fiscal policy field is that it might not have the necessary *legitimacy*, as many citizens in EU countries seem to feel that integration has proceeded too fast. There might also be strong political resistance against such fiscal policy co-operation involving only some EU countries: the fiscally less disciplined countries might oppose it because it would expose their own fiscal problems more clearly, and the smaller countries might not want to provoke the larger ones. There might also be fears that the cohesion of the EU is put at risk.

The remaining option to offset the adverse effects of the weakening of the stability pact would then be to strengthen *national institutions* promoting fiscal discipline. This could be seen as the natural consequence of a development that has shown that enforcement of fiscal rules at the European level does not command the required legitimacy. An appropriate national framework should contain at least three components: (i) well-defined *policy objectives* (regarding the budget balance or the path of government debt over the business cycle, government expenditure levels and macroeconomic stabilisation); (ii) guidelines to ensure the *transparency* of fiscal policy; and (iii) *incentives* to avoid deviations of government policies from pre-set objectives. A key role should be played by a national *Fiscal Policy Council*, consisting of independent experts, with strong powers to monitor the consistency between *ex post* government policy and *ex ante* objectives.

Such an independent council would *constrain* discretionary fiscal policy making. By providing a countervailing force to distortions in the political process, a Fiscal Policy Council could help align policies better with the preferences of the majority of citizens. A council could play different roles, ranging from providing authoritative policy evaluations to direct involvement in decision-making. One option would be to require governments to base their budget calculations on the forecasts of the Fiscal Policy Council. A stronger reform would be to let the budget process start with recommendations from the council and to oblige the government to defend any deviations from these recommendations in an open parliamentary hearing and a subsequent parliamentary debate. A far-reaching proposal would

be to give the Fiscal Policy Council the power to *veto* political decisions on the annual budget balance, and possibly also on the size of government expenditures, when it considers them to constitute major deviations from the objectives pre-determined by the parliament. Such a veto should not be absolute, but specific requirements might have to be met to override it: these might include a renewed single-majority decision by the same parliament, a renewed decision with a qualified majority by the same parliament or dissolution of the parliament and a renewed single-majority decision by a newly elected parliament.

The proposal on national fiscal policy councils raises complex issues of where to draw the line between political and technocratic decision-making (the latter being defined as decisions taken, not by elected politicians, but by civil servants acting on the basis of objectives that have been determined by the political system) in a democracy. Which type of decision-making is preferable in a specific policy area depends on a number of criteria. Technocratic decision-making is in general more appropriate when effective decisions require a high degree of professional competence and careful processing of information, when political objectives are possible to specify clearly *ex ante*, and when the political process is characterised by excessive short-termism. Political decision-making is effective when professional competence is less important, when it is difficult for the political system to specify objectives in advance, when there are large risks that civil servants pursue own goals instead of the politically pre-specified ones, and when there are important interactions among different policy areas (so that the success of one policy depends to a large extent on the co-ordination with other policies). Evaluating these criteria, there appears to be as strong a case for shifting the balance in favour of technocratic decision making for fiscal policy as there was for delegating monetary policy to independent central banks. This may help to counter a political bias towards excessive deficits.

It would be theoretically possible to agree on common guidelines for national fiscal policy institutions at the EU level or to base enhanced co-operation within a subgroup of member states on such guidelines. But in practice this is not feasible. An obvious reason is that the reforms of national fiscal policy institutions outlined here are highly controversial. Any attempt to impose such reforms as an EU initiative would be likely to add to EU scepticism among many citizens. If the proposals are to stand any chance of being accepted, they would have to be rooted in national experiences: there would be no way around a drawn-out debate at the national level, in which citizens need to be convinced that the reforms are in the

national self-interest. The best one could hope for is that some countries start experimenting with new forms of fiscal policy decision making and that these can in the long run serve as good examples for others to follow. One could see this as an application of the *open method of co-ordination* used in some areas of EU co-operation, for example employment policy, where the objective is to identify "best-practice solutions" through the evaluation of diverse country experiences. This conclusion is not, however, very optimistic, as it implies that it may take a long time to find a substitute for the watered-down stability pact. This means that the fiscal situation in many European countries may have to get much worse before getting any better.

The essay is structured in the following way.

- Section 2 discusses the main reasons why unconstrained discretionary fiscal policy tends to result in a government deficit bias.
- Section 3 summarises the main EU fiscal rules, reviews the way the rules have been applied in the past, and surveys the recent debate.
- Section 4 reviews and evaluates the reform of the stability pact.
- Section 5 discusses which possibilities remain for upholding fiscal discipline.

2 THE ARGUMENTS FOR CONSTRAINTS ON FISCAL POLICY

In the recent debate on the stability pact, there has been a tendency to play down the arguments in favour of fiscal rules at the EU level. So, it may be pertinent to repeat these arguments. The large government budget deficits experienced by most European countries in the 1975–95 period provides one strong motive for such rules. Other arguments are the strong theoretical presumption that unconstrained fiscal policy is characterised by a deficit bias and that such a bias may be exacerbated in a monetary union.

2.1 Earlier experiences

As seen from Table 1, there was a marked deterioration in government budget balances in the 1970s across almost all EU-15 countries. Figure 1 shows how the period from the late 1970s to the mid 1990s was characterised by government budget deficits (net financial government borrowing) of the order of magnitude of 3-5 per cent of GDP for EU-15 as a whole. As a consequence, government gross debt in the EU-15 increased from around 40 per cent of GDP in the late 1970s to more than 70 per cent in 1995, as shown in Figure 2. Table 2 shows that the highest debt ratios were reached in Belgium (134.0 per cent), Italy (124.3 per cent) and Greece (108.7 per cent). But the increases in debt ratios from the early 1970s to the mid 1990s in most of the other EU-15 countries were also very large. Of the EU countries experiencing large debt increases in the 1970s and early 1980s, only Denmark and Ireland managed to reverse the earlier trends and start reducing debt ratios again during the 1980s. As seen from Figures 1 and 2, the weakening of government finances in the 1975–95 period was not specific to Europe; a similar development occurred at the same time in the US. Such large deteriorations in government finances in peacetime were a historically unique phenomenon, which caused alarm.

2.2 Theoretical reasons for a deficit bias

Debt-financed fiscal expansion may be an appropriate way of counteracting a cyclical downturn. An increase in government debt may also be a rational response to a temporary rise in government expenditures (for example, military spending in the case of an international conflict), which allows tax rates to be smoothed over time and thus tax distortions to be minimised.[2] But it is difficult to come up with such explanations for the increases in government debt in the 1980s and early 1990s. Instead, these

[2] This argument was first developed by Barro (1979).

Table 1 Net government lending in the EU-15 countries (per cent of GDP), 1970-2005

	1970	1975	1980	1985	1990	1995	2000	2005
Austria	1.2	-2.4	-1.7	-2.4	-2.4	-5.7	-1.5	-2.0
Belgium	-2.2	-5.0	-8.6	-8.9	-5.4	-4.4	0.2	-0.2
Finland	4.2	4.5	3.3	2.8	5.3	-3.9	7.1	1.7
France	0.9	-2.3	0.0	-2.8	-1.5	-5.5	-1.4	-3.0
Germany	0.2	-5.6	-2.9	-1.2	-2.1	-3.3	1.3	-3.3
Greece	0.7	-2.9	-2.6	-11.6	-15.9	-10.2	-4.1	-4.5
Ireland	-3.9	-11.5	-11.6	-10.2	-2.2	-2.1	4.4	-0.6
Italy	-3.3	-10.5	-8.7	-12.5	-11.0	-7.6	-0.6	-3.6
Luxembourg	2.8	1.0	-0.4	6.3	4.7	2.5	6.2	-1.5
Netherlands	-1.1	-2.7	-4.1	-3.5	-4.9	-4.2	2.2	-2.0
Portugal	2.9	-4.0	-8.4	-10.1	-4.9	-5.5	-2.9	-6.2
Spain	0.6	0.0	-2.5	-6.2	-4.2	-6.6	-0.9	0.0
Euro area	-0.3	-4.5	-3.4	-4.9	-4.3	-5.0	0.1	-2.6
Denmark	4.0	-1.3	-3.2	-2.0	-1.0	-2.3	2.6	2.1
Sweden	4.3	2.6	-3.9	-3.7	4.0	-7.0	5.0	0.8
UK	3.0	-4.5	-3.4	-2.9	-0.9	-5.8	3.8	-3.0
EU-15	0.5	-4.1	-3.4	-4.5	-3.5	-5.1	1.0	-2.5

Notes: 2005 values are estimates using data up to 16 March 2005. From 1995 and onwards the ESA 95 definition has been used, whereas the ESA 79 definition has been used for earlier years.

Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

increases are more likely to have resulted from a government *deficit bias*. When decisions are discretionary, that is when policy makers are free at any point in time to choose the fiscal policy they then find the best, there may be an inherent tendency for short-termism leading to excessive debt accumulation.

The research literature suggests a number of explanations for such a deficit bias.

1. The simplest explanations are based on *fiscal illusion* and *myopic behaviour*. Voters may fail to realise the future costs of government budget deficits: they may not understand the extent to which current tax cuts or government expenditure increases will lead to future tax rises or expen-

Table 2 Gross government debt in the EU-15 countries (per cent of GDP), 1970-2005

	1970	1975	1980	1985	1990	1995	2000	2005
Austria	19.1	23.6	36.6	49.8	56.8	68.8	66.7	64.4
Belgium	63.9	59.2	78.6	122.3	129.2	134.0	109.1	94.9
Finland	11.7	6.7	11.5	16.2	14.2	57.1	44.6	44.3
France	-	-	19.8	30.8	35.1	54.6	56.8	66.2
Germany	18.2	24.3	31.2	40.7	42.3	57.0	60.2	68.0
Greece	19.8	20.2	25.0	53.6	79.6	108.7	114.0	110.5
Ireland	49.7	59.0	69.8	101.7	94.2	82.0	38.3	29.8
Italy	37.9	57.3	58.2	82.3	97.2	124.3	111.2	105.6
Luxembourg	23.0	14.8	11.3	11.7	5.4	6.7	5.5	7.8
Netherlands	-	40.8	45.9	70.3	76.9	77.2	55.9	57.6
Portugal	-	22.2	32.3	61.5	58.3	64.3	53.3	66.5
Spain	15.0	12.3	16.8	42.3	43.6	63.9	61.1	46.5
Euro area	-	-	34.0	51.7	57.7	73.6	70.4	71.7
Denmark	-	7.1	39.8	76.4	63.1	73.2	52.3	40.5
Sweden	27.3	26.4	40.0	61.9	42.0	73.7	52.8	50.3
UK	78.7	61.2	53.2	52.7	34.0	51.8	42.0	41.9
EU-15	-	-	38.2	53.1	53.9	70.8	64.1	65.0

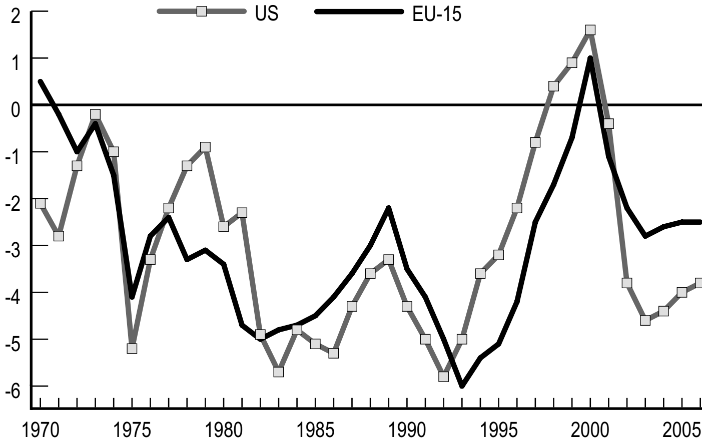
Note: 2005 values are estimates using data up to 16 March 2005.

Source: *Statistical Annex of European Economy*, Spring 2005, European Commission.

diture reductions. Hence, policies that result in government budget deficits tend to be popular. Such irrationality of voters can make it rational for governments to engineer *political business cycles*, that is to try to boost re-election chances through unfinanced tax reductions or expenditure increases. According to a similar argument, myopia also tends to make fiscal policy asymmetric over the business cycle: it is easier for governments to get political support for stimulating the economy through expansionary fiscal action in downturns than for restraining it through contractive action in upswings. The result is a deficit bias over the cycle.[3]

[3] See, for example, Leibfritz *et al.* (1994), Buti *et al.* (1997) or Public Finances in EMU (2001). A related argument focuses instead on distribution conflicts between generations. If the present generation does not care about the welfare of future generations, it is rational for it to re-distribute income in its own favour through accumulation of government debt.

Figure 1 Net government lending (per cent of GDP), 1970-2006



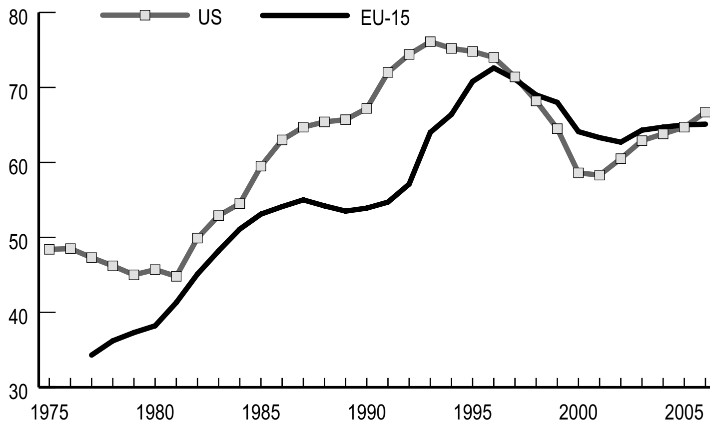
Notes: EU-15: Until 1994 ESA-79 definition, from 1995 ESA-95 definition. 2005 and 2006 values are estimates using data up to 16 March 2005.

Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

2. A more sophisticated explanation of the "short-termism" of governments focuses on *political polarisation* and *strategic considerations* of political parties likely to alternate in office. If these parties have different preferences for types of government expenditure, an incumbent government, facing uncertainty over re-election prospects, may want to run a budget deficit now, as this allows it to increase the government expenditure it prefers. The associated increase in government debt imposes a cost in the form of lower government expenditure in the future. But an incumbent government will assign a low weight to this future cost, if there is a high probability that it will lose the next election and be replaced by a government with a preference for other types of government spending. This prospect increases the effective discount rate of the current government, so that it cares less about the future than is socially desirable.[4] It follows that the larger the probability of electoral defeat

[4] If the political parties alternating in office are assumed to be representative of different groups of voters, the socially desirable outcome is a weighted average of the outcomes preferred by the parties.

Figure 2 Gross government debt (per cent of GDP), 1975-2006



Note: 2005 and 2006 values are estimates using data up to 16 March 2005.

Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

for the incumbent government and the larger the difference in preferences between parties, the larger the deficit bias tends to be.[5]

3. Another set of explanations views the government deficit bias as a *common-pool* problem similar to the "tragedy of the commons" that may occur in, for example, marine fisheries or public grazing lands.[6] The idea is that special interest groups lobby for spending on their preferred programmes without considering the full budgetary costs. Each group

[5] The original idea is due to Tabellini and Alesina (1990). Similar reasoning stresses instead that political parties alternating in government may have different preferences for the total amount of government spending (Persson and Svensson 1989). A "right-wing" government with a preference for low government spending may make deficit-financed tax cuts in order to raise current-period private consumption and constrain government spending by a future "left-wing" government.

[6] See Ostrom, Gardner and Walker (1994) for a review of the common-pool problem of natural resources. Weingast, Shepsle and Johnsen (1981) were the first to use this model to explain excessive government spending. Hallerberg and von Hagen (1999) and Velasco (1999, 2000) have developed dynamic models explaining how this mechanism can cause a deficit bias.

tries to "grab" as much as possible of net government assets (the common resource): this is perceived to have a low cost for the group, because it can expect to get only a fraction of the common future return on the assets. The consequence is overspending and a deficit bias for the same reason as there is overexploitation of natural resources in the absence of clearly defined property rights. One can think of several possible constellations of interest groups: geographical districts or subgovernments (Argentina and Brazil are frequently cited examples), various socio-economic groups, different parties in a coalition government or in the parliament in the case of a minority government, "spending ministers" in the government, state enterprises *etc*. The deficit bias arising from this mechanism is likely to be stronger the more fragmented government spending decisions are.

4. An additional explanation for a government deficit bias is *dynamic time inconsistency*. It is well known that monetary policy run by politically dependent central banks may be subject to an inflation bias.[7] The explanation is that monetary policy makers may be tempted to pursue an expansionary monetary policy, increasing aggregate demand and causing inflation, once money wages have been set in long-term wage contracts: in this situation such a policy tends to reduce real labour costs and thus to raise employment. But in the end, this policy behaviour will be anticipated: money wages will adjust to subsequent inflation already *ex ante* and the policy will therefore fail *ex post* to reduce real labour costs and unemployment. Fiscal policy may be exposed to similar temptations as monetary policy, as it represents an alternative way of influencing aggregate demand: under discretionary decision-making there is thus an *ex ante* incentive for fiscal policy makers to expand aggregate demand by running deficits in order to allow inflation surprises that reduce real labour costs. However, as this policy becomes anticipated, it will be as inefficient as monetary policy in raising employment: the only long-term result will be a deficit bias. This deficit bias is likely to be stronger if the inflation bias of monetary policy is reduced, because the inflation costs of budget deficits will be lower, the more focused the central bank is on price stability. This suggests that the reductions in inflation associated with more independent central banking may exacerbate the deficit bias by *relocating* the time inconsistency problem from monetary to fiscal policy.[8]

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[7] The original insight is due to Kydland and Prescott (1977), but it was first applied to monetary policy in more detail by Barro and Gordon (1983a,b).

[8] An early model of this is Agell, Calmfors and Jonsson (1996). See also McCallum (1995) and Castellani and Debrun (2005).

The arguments above explain why discretionary political decisions on fiscal policy may lead to larger government deficits and debt than are in the interest of the majority of voters. In most theoretical models, the welfare costs of excessive debt accumulation arise because the time profiles of government and/or private consumption are distorted when current consumption is substituted for future consumption. In addition, to the extent that real interest rates are driven up (either directly because of an increased demand for loanable funds or indirectly because of the central bank's need to defend price stability through higher short-term interest rates), investment is crowded out, which reduces future output.[9] Higher inflation (with likely negative effects on the level and/or growth of output) may be another adverse consequence of a deficit bias, as the higher the debt level, the stronger are the incentives for central banks to reduce the real value of outstanding government debt.

The discussion on government debt is often cast in terms of the *sustainability* of government finances. With a high rate of debt accumulation, the government may ultimately become insolvent. This happens if the level of net government debt exceeds the discounted value of future primary budget surpluses.[10] Insolvency implies that the government defaults on its debt. Such default has large potential costs: arbitrary re-distribution of wealth, reductions in the government's future borrowing possibilities, and possibly also systemic financial crisis as lenders to the government make capital losses and there are contagion effects on the perceived creditworthiness of other borrowers.[11] According to the so-called *fiscal theory of price determination*, government insolvency will wrest control of inflation out of the hands of the central bank and trigger a market-determined jump in the price level that restores solvency by reducing the real value of outstanding nominal government debt.[12] Alternatively, a large accumulation of government debt can be very costly because ultimately dramatic consolidation measures are necessary to ensure the sustainability of government

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[9] For evidence on real interest rate effects, see, for example, Gale and Orzag (2003) and Chinn and Frankel (2003). The latter address the issues of to what extent government bonds from different countries are substitutable and whether or not there exists a unified world capital market. The authors find that higher current and expected government budget deficits in European countries are associated with higher long-term interest rates there also after controlling for US long-term interest rates.

[10] The primary budget surplus is the difference between current receipts and expenditures excluding net interest payments. See, for example, Buiter and Grafe (2004) or Wyplosz (2005).

[11] Note that higher debt accumulation than is socially desirable does not have to mean that government finances are unsustainable. But government default on its debt is most likely socially undesirable.

[12] See, for example, Canzoneri and Diba (2001).

finances. Financial market reactions to large government debt build-ups typically come late, but when they come, they are usually very sudden and force governments to cut expenditures and increase taxes in improvised and highly inefficient ways.

The risk of a deficit bias under discretionary political decision-making provides a general argument for *constraints* on fiscal policy. *Fiscal rules* represent one form of such constraints. The underlying idea is that commitment to such rules at the "constitutional level" are easier to uphold than commitments to specific discretionary policy actions, because violations of rules impose larger reputational costs on decision-makers.[13] This does not, however, explain why such rules should be supranational – like the EU fiscal rules – rather than national. In principle, there exist two sets of motivations for such supranationality.

The first rationale for supranational rules is that they may be more effective than national rules even if the deficit bias arises for purely domestic reasons. One possible explanation is that self-imposed rules at the national level can be difficult to enforce, because the distinction between the agent (the government) that is to be monitored and the principal (the legislature) that is to monitor compliance is blurred in a parliamentary system. This provides an argument for an *external enforcer* of the rule even if the deficit bias has domestic causes. It is also often believed that supranational rules are more likely to be observed than national ones because violations of international agreements carry additional costs in terms of loss of international prestige and trustworthiness in general.[14] A related motive for the original establishment of the EU fiscal rules was the much weaker political resistance to institutional changes promoting fiscal discipline at the European than at the national level.[15] The EMU simply offered a unique *window of opportunity*, as it required the establishment of new institutions anyway and the political forces opposing fiscal restraint were not well organised at the European level.

The second type of justification for supranational fiscal rules is that policies in one country may have negative spillover effects on other countries that are not duly taken account of at the national level. In particular, a national deficit bias may be exacerbated in a monetary union because part of the cost of government debt accumulation for an individual country can be shifted on to the other member countries. In a country that has its own

[13] See Kopits and Symansky (1998) for an elaboration of this argument.
[14] See, for example, Kopits and Symansky (1998).
[15] See Calmfors *et al.* (1997) and EEAG (2003) for expositions of this point.

currency and a flexible exchange rate, a large government budget deficit is likely to trigger increases in both short-term interest rates (because of the response of the national central bank to the implied threats to price stability) and long-term ones (because of changes in inflation expectations in financial markets) as well as exchange rate changes. But such reactions will be eliminated if a country is a member of a currency area with a common monetary policy that responds only to area-wide developments. This means that an important disciplining force for fiscal policy has disappeared.

Another reason for a worsening of the deficit bias in the EMU is the probability that other countries will be forced in the end to *bail out* an individual country that runs unsustainable government deficits.[16] This creates a so-called *moral hazard* problem, as the incentives at the national level to avoid such deficits are reduced. *Ex post*, other countries in a monetary union face a strong temptation to bail out a defaulting government, as government bankruptcy in one country can cause large capital losses for lenders in other countries and lead to systemic financial crisis.

A bail-out can be direct if other governments assume debt-servicing costs or if the ECB buys up the debt of the government in question. But the largest risk is indirect bail-outs through inflation. The argument is that, even if the ECB tries *ex ante* to achieve price stability, it will not be able *ex post* to withstand pressure to reduce the real value of outstanding debt through inflation, if debt levels are very high. When a country has its own currency, its government has an incentive to fully consider the risk that large debt accumulation will in the end force the central bank to allow higher inflation. But in the euro area, the budget deficit of each government has only a small effect on the total stock of euro-dominated government debt and hence on the incentives of the ECB to allow inflation. Therefore, each government will not take all the effects of its debt accumulation into account. In the absence of rules constraining fiscal behaviour, this may ultimately result in excessive levels of both government debt and inflation.[17] Such fears that fiscal indiscipline – mainly in Italy and other Southern European countries – would jeopardise price stability in the whole euro area was a major driving force behind the original German proposals on the stability pact in 1995.[18]

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[16] See, for example, Buiter, Corsetti and Roubini (1993), Calmfors *et al.* (1997) or Beetsma (2001).

[17] This mechanism has been formally modelled by Chari and Kehoe (2004).

[18] A detailed account of the *genesis* of the stability pact is given by Stark (2001). See also Costello (2001).

3 THE EU FISCAL RULES

The main fiscal rules in the EU were set out in the 1991 Maastricht Treaty. They were complemented in 1997 by the agreement on the stability pact (formally the Stability and Growth Pact), which defined the operational contents of some of the Treaty stipulations more clearly. The original pact consisted formally of two Ecofin Council Regulations (1466/97 and 1467/97) and a European Council Resolution (17 June, 1997). The two original Regulations were amended in June 2005 in two new Ecofin Council Regulations (1055/2005 and 1056/2005) on the basis of the agreement among ministers in the Ecofin Council on a revision of the stability pact in March the same year (Ecofin Report 7423/05).

3.1 Basic stipulations

Formally, the basic fiscal rules remain the same after the revision of the stability pact. The main *economic contents* are:

1. National central banks, the ECB, other EU institutions and other EU governments are prohibited from bailing out an individual EU government that cannot meet its debt obligations. In addition, all kinds of privileged access of EU governments to domestic credit institutions are prohibited.
2. Government budget deficits as a ratio of GDP shall not exceed (a reference value of) three per cent unless "either the ratio has declined substantially and continuously and reached a level close to the reference value or, alternatively, the excess over the reference value is only exceptional and temporary and remains close to the reference value". A deficit above three per cent of GDP shall be considered exceptional and temporary if it results from "an unusual event outside the control of the Member State concerned and has a major impact on the financial position of the general government" or from "a severe economic downturn".[19]
3. Gross government debt shall not exceed 60 per cent of GDP or, if the debt ratio is larger, it shall be "sufficiently diminishing" and approaching the 60-per-cent level "at a satisfactory pace".
4. Governments shall adhere to a medium-term objective for their budgetary positions, that is an objective for the *cyclically adjusted budget*

[19] Note that, according to the Maastricht Treaty, the obligations of the UK differ from those of the other EU countries. Whereas other countries are obliged to "avoid excessive deficits", the UK is only obliged to "endeavour to avoid" them, as long as the country has not adopted the common currency.

balance.[20] According to the original stability pact, the medium-term objective was a budget position of "close to balance or in surplus". According to the revised pact, the medium-term objective is differentiated among countries, as will be discussed in Section 4.1.

The Treaty and the stability pact also set out a number of *procedural rules*. Some of them are designed to prevent large budget deficits from arising in the first place (the *preventive arm* of the fiscal framework in EU jargon), whereas others are designed to deal with them once they have arisen (the *corrective* or *dissuasive* arm of the framework).

The preventive elements include regular multilateral surveillance of member states' budgetary positions. Member states are obliged to submit *stability programmes* (eurozone countries) or *convergence programmes* (non-eurozone countries) specifying budget targets. The Ecofin Council gives *opinions* on these programmes, based on recommendations from the Commission. In the event of a significant divergence of the budgetary outcome from the target and an implied risk that the three-per-cent-of-GDP-deficit ceiling will be breached, the Council can, on a recommendation from the Commission, issue a so-called *early warning* to a member state.[21]

The corrective (dissuasive) elements of the procedural rules consist of the *excessive deficit procedure*. It defines a scale of gradually escalating steps to deal with breaches of the deficit and debt criteria. The steps are as follows.

1. The *Commission* prepares a *report.* When drawing up such a report, the Commission "shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".
2. The *Economic and Financial Committee*, consisting of top civil servants from the ministries of finance and national central banks of the member states, formulates an *opinion* on the report of the Commission.
3. If the *Commission* then considers that an actual, or forecast, deficit is excessive, it shall address an *opinion* regarding this to the Ecofin Council as well as a *recommendation* on which policy action is appropriate

[20] The cyclically adjusted budget balance is obtained by recalculating tax incomes as well as government expenditures under the assumption that output is at its potential (equilibrium) level. See, for example, EEAG (2003).

[21] The revision of the stability pact implies that the Commission can in the future issue "policy advice" as a substitute for early warnings from the Ecofin Council. This is discussed in greater detail in Section 4.1.

for correcting the deficit. Note that it is not only a deficit above three per cent of GDP that may be regarded as an excessive deficit. Provided that the debt ratio is above 60 per cent, an increase in the debt ratio, or "too slow" a reduction of it, can also be considered an excessive deficit.

4. Based on the opinion from the Commission, the *Ecofin Council* takes a *formal decision* on whether a deficit is *excessive.* If this is found to be the case, the *Council* gives the country in question a *recommendation* on appropriate measures to correct it. This recommendation contains two deadlines: one for taking effective action and one for actually correcting the deficit.
5. If a member state fails to heed the recommendation on corrective action, the *Ecofin Council* can give *notice* to the state. This stronger request – which is a necessary step before sanctions – can only be made to eurozone countries, but not to EU countries outside the eurozone. Only a renewed recommendation can be given to the latter.
6. If a eurozone country fails to take corrective action as requested, the *Ecofin Council* can require the country to make a *non-interest bearing deposit* with the Commission. The deposit consists of a fixed component of 0.2 per cent of GDP and a variable component (0.1 per cent of GDP for each whole percentage point excess of the deficit ratio over three per cent). If the excessive deficit persists, the Council may each year require an additional deposit: these later deposits include only the variable component. In any year, there is an upper limit for the deposit of 0.5 per cent of GDP. These pecuniary sanctions are tied only to violations of the deficit criterion: no such sanctions can be imposed in the case of violations of the debt criterion.
7. If, in the opinion of the *Ecofin Council*, an excessive deficit has not been corrected two years after a deposit has been made, the deposit should be converted into a *fine* to be distributed among those members of the eurozone that do not have an excessive deficit.

Once a member state that has been found to have an excessive deficit has complied with the decisions of the Council and reduced the deficit below three per cent of GDP, the excessive deficit procedure can be closed ("abrogated" in EU jargon). This requires a formal Council decision.

The various stipulations in the rules have different legal status. The no-bail-out provisions, the three-per-cent-of-GDP deficit ceiling (and the general formulations on exemptions), the 60-per-cent-of-GDP debt ceiling (and the requirement that higher debt ratios must be diminishing) as well as the general stipulations on multilateral surveillance and the steps in the

excessive deficit procedure are all in the Treaty. But the medium-term budgetary objective, the specifics of multilateral surveillance (the provisions on stability and convergence programmes, early warnings *etc.*), and the size of deposits and fines are set out in the stability pact. The pact also specifies a time schedule for the different steps in the excessive deficit procedure. According to the original pact, an excessive deficit shall be corrected the year after it has been identified by the Council (usually the second year after it has arisen) "unless there are special circumstances" (which were not specified). The revised pact details "the special circumstances" and also allows for further extensions of the deadlines, as will be discussed in Section 4.1.

3.2 How have the rules worked?

This section discusses how the fiscal rules worked until they were revised in March 2005. Such an analysis can be done in two ways. The first is to examine how the stipulated procedures have been applied formally. The second way is to analyse to what extent the rules have affected fiscal behaviour.

3.2.1 The formal application of the earlier rules[22]

Tables 3a and 3b show actual budget deficits in recent years. As can be seen, there have been a number of cases where deficits in the old EU countries have exceeded three per cent of GDP since the start of the monetary union in 1999. These include Portugal in 2001, Germany and France from 2002, the Netherlands in 2003, the UK in 2003 and 2004, Greece in all the years shown (though the excesses over the three-per-cent-of-GDP limit from 1997 and onwards did not become known until 2004/05) and Italy from 2003 (according to revised figures that became available first in 2005). Of the ten new EU member states, six had deficits above three per cent of GDP in their first year of membership 2004: Cyprus, the Czech Republic, Hungary, Malta, Poland and the Slovak Republic.

Table 4 shows cyclically adjusted net lending for the EU-15 countries according to calculations by the European Commission. Comparing Tables 3a and 4, it is seen that the cyclically adjusted deficit was also above the three-per-cent limit in most cases when the actual deficit was so (12 out of 18 cases in the 1999-2004 period). The exceptions are Greece in 1999, the Netherlands in 2003, Italy in 2003 and 2004, and the UK in 2003 and

[22] See Section 5.1 for a discussion on how the procedures have been applied *after* the revision of the stability pact.

Table 3a Net government lending in the EU-15 countries (per cent of GDP), 1997-2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Austria	-1.8	-2.4	-2.3	-1.5	0.3	-0.2	-1.1	-1.3	-2.0	-1.7
Belgium	-2.0	-0.6	-0.4	0.2	0.6	0.1	0.4	0.1	-0.2	-0.6
Finland	-1.3	1.6	2.2	7.1	5.2	4.3	2.5	2.1	1.7	1.6
France	-3.0	-2.7	-1.8	-1.4	-1.5	**-3.2**	**-4.2**	**-3.7**	-3.0	-3.4
Germany	-2.7	-2.2	-1.5	1.3	-2.8	**-3.7**	**-3.8**	**-3.7**	**-3.3**	-2.8
Greece	**-6.6**	**-4.3**	**-3.4**	**-4.1**	**-3.6**	**-4.1**	**-5.2**	**-6.1**	**-4.5**	**-4.4**
Ireland	1.1	2.4	2.6	4.4	0.9	-0.4	0.2	1.3	-0.6	-0.6
Italy	-2.7	-2.8	-1.7	-0.6	-3.0	-2.6	**-3.1**	**-3.1**	**-3.6**	**-4.6**
Luxembourg	2.9	3.2	3.4	6.2	6.2	2.3	0.5	-1.1	-1.5	-1.9
Netherlands	-1.1	-0.8	0.7	2.2	-0.1	-1.9	**-3.2**	-2.5	-2.0	-1.6
Portugal	**-3.6**	**-3.2**	-2.8	-2.9	**-4.4**	-2.9	-2.9	-2.9	**-6.2**	**-4.8**
Spain	**-3.2**	-3.0	-1.2	-0.9	-0.5	-0.3	0.3	-0.3	0.0	0.1
Euro area	-2.7	-2.3	-1.3	0.1	-1.7	-2.4	-2.8	-2.6	-2.5	-2.5
Denmark	0.4	1.2	3.3	2.6	3.2	1.7	1.2	2.8	2.1	2.2
Sweden	-0.9	1.8	2.5	5.0	2.5	-0.3	0.2	1.4	0.8	0.8
UK	-2.2	0.1	1.0	3.8	0.7	-1.7	**-3.3**	**-3.1**	-3.0	-2.7
EU-15	-2.5	-1.7	-0.7	1.0	-1.1	-2.2	-2.8	-2.6	-2.5	-2.5

Notes: 2005 and 2006 values are estimates using data up to 16 March 2005. The 2003 and 2004 figures for Italy are revised ones from Eurostat 23 May 2005. The 2003 and 2004 figures for the UK are revised ones from *Report from the Commission on the UK* (2005). Deficits in excess of three per cent of GDP are shown in bold.

Source: *Statistical Annex of European Economy*, Spring 2005, European Commission.

2004. In the majority of cases (12 out of 18 in the 1999-2004 period), cyclically adjusted deficits were smaller that the actual deficits, when actual deficits were above the three-per-cent limit. This implies that most violations of the deficit ceiling have occurred in cyclical downturns. The exceptions, where the cyclically adjusted deficits were *larger* than the actual deficits in violation years (after the EMU start), are Portugal in 2001, France in 2002, and Greece in 2001-2004. In these cases, violations of the deficit ceiling thus took place during cyclical upswings.

Tables 5a and 5b show government debt ratios. Here, too, there have been violations of the rules. In several cases in the 1999–2004 period, debt

Table 3b Net government lending in the new EU countries (per cent of GDP), 1997-2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Cyprus	-	**-4.2**	**-4.4**	-2.4	-2.3	**-4.5**	**-6.3**	**-4.2**	-2.9	-1.9
Czech Republic	-2.4	**-5.0**	**-3.6**	**-3.7**	**-5.9**	**-6.8**	**-11.7**	-3.0	**-4.5**	**-4.0**
Estonia	1.7	-0.3	-3.7	-0.6	0.3	1.4	3.1	1.8	0.9	0.5
Hungary	-	-	-	-2.4	**-3.7**	**-8.5**	**-6.2**	**-4.5**	**-3.9**	**-4.1**
Latvia	1.5	-0.6	**-5.4**	-2.8	-2.1	-2.7	-1.5	-0.8	-1.6	-1.5
Lithuania	-1.2	-3.0	**-5.6**	-2.5	-2.0	-1.5	-1.9	-2.5	-2.4	-1.9
Malta	-	-	-	**-6.3**	**-6.4**	**-5.9**	**-10.5**	**-5.2**	**-3.9**	-2.8
Poland	-4.0	-2.1	-1.4	-1.6	**-3.9**	**-3.6**	**-4.5**	**-4.8**	**-4.4**	**-3.8**
Slovak Republic	**-6.2**	**-3.8**	**-7.1**	**-12.3**	**-6.0**	**-5.7**	**-3.7**	**-3.3**	**-3.8**	**-4.0**
Slovenia	-	-	-	**-3.5**	-2.8	-2.4	-2.0	-1.9	-2.2	-2.1
EU-10	**-3.5**	-2.9	-2.7	-2.9	**-4.1**	**-4.8**	**-5.7**	**-3.8**	**-3.9**	**-3.6**

Notes: 2005 and 2006 values are estimates using data up to 16 March 2005. Deficits in excess of three per cent of GDP are shown in bold.

Source: *Statistical Annex of European Economy*, Spring 2005, European Commission.

ratios above 60 per cent of GDP were not falling as required by the rules. The major offenders were France (with an increase from 59.0 per cent in 2002 to 65.6 in 2004) and Germany (with an increase from 59.4 per cent in 2001 to 66.0 in 2004). In Portugal, the debt ratio increased from 58.5 per cent in 2002 to 61.9 per cent in 2004. Minor increases (or no decreases) in single years occurred in Austria (1999 and 2001) and Greece (2000, 2001 and 2004). Recorded debt ratios have recently been falling very slowly in Italy. Of the new EU states, it is only Cyprus and Malta that have debt ratios above 60 per cent: in both these countries, debt ratios increased in 2004.

Excessive deficit procedure

Table 6 gives an overview of how the excessive deficit procedure has been applied. The only case where the procedure has *clearly* been used as originally envisaged is the Netherlands, which recorded a budget deficit of 3.2 per cent of GDP in 2003. The country was placed in the excessive deficit category by the Ecofin Council in 2004 and given until 2005 to reduce the deficit below the three-per-cent limit. In fact, such vigorous action was taken that this was achieved already in 2004.

Table 4 Cyclically adjusted net government lending in the EU-15 countries (per cent of GDP), 1997-2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Austria	-1.6	-2.4	-2.6	-2.5	0.0	-0.3	-0.8	-1.1	-1.9	-1.6
Belgium	-1.9	-0.3	-0.7	-1.0	0.1	0.5	1.2	0.6	0.3	-0.2
Finland	-1.3	0.0	0.8	4.7	4.7	4.5	3.2	2.4	1.9	1.8
France	-2.2	-2.5	-2.0	-2.2	-2.4	**-3.6***	**-4.0**	**-3.6**	-2.8	**-3.1**
Germany	-2.3	-1.8	-1.3	-1.7	**-3.2**	**-3.6**	**-3.2**	**-3.3**	-2.8	-2.3
Greece	**-3.6**	**-3.5**	-2.8	**-3.8**	**-4.2***	**-4.3***	**-5.7***	**-7.1***	**-5.4***	**-5.3***
Ireland	1.1	2.0	1.5	2.7	-0.2	-1.4	0.2	1.6	-0.1	0.1
Italy	-2.5	**-3.1**	-2.1	-2.7	**-3.9**	-2.9	-2.6	-2.4	-2.9	**-4.0**
Luxembourg	4.1	3.2	2.3	3.1	5.2	2.5	1.3	-0.3	-0.6	-0.6
Netherlands	-0.9	-1.6	-1.0	-0.6	-1.4	-2.3	-2.0	-1.2	-0.4	0.0
Portugal	-2.7	**-3.4**	**-3.4**	**-4.0**	**-5.0***	-2.9	-2.2	-2.1	**-5.3**	**-3.8**
Spain	-2.6	-2.9	-1.4	-1.7	-1.1	-0.6	0.2	-0.3	0.0	0.2
Euro area	-2.2	-2.2	-1.6	-1.8	-2.4	-2.6	-2.4	-2.4	-2.1	-2.1
Denmark	-0.3	0.6	2.3	1.2	1.9	1.4	2.0	3.4	2.5	2.4
Sweden	-0.3	3.7	3.0	4.2	2.9	0.3	1.3	1.7	0.8	0.7
UK	-2.4	-0.2	0.8	0.8	0.3	-1.6	-3.0	-3.0	-2.9	-2.6
EU-15	-2.1	-1.6	-0.9	-1.1	-1.7	-2.3	-2.3	-2.3	-2.1	-2.1

Notes: 2005 and 2006 values are estimates using data up to 16 March 2005. Cyclically adjusted deficits in excess of three per cent of GDP are shown in bold. An asterisk marks if such a cyclically adjusted deficit is larger than the actual deficit in a year when the actual deficit exceeds three per cent of GDP.

Sources: 1997 values: *Statistical Annex of European Economy*, Autumn 2002, European Commission. 1998-2006 values: *Statistical Annex of European Economy*, Spring 2005, European Commission.

The UK case is more problematic. The 3.2 per cent of GDP deficit in 2003/04 triggered a report from the Commission, where it concluded that the deficit should not be considered excessive because the "overdraft" was likely to be only "temporary".[23] This judgement was obviously incorrect, as there was a new overdraft in 2004/05. This is discussed further in Section 5.1.2.

[23] *Report from the Commission on United Kingdom* (2004). Note that according to the Treaty, UK deficits are evaluated on a fiscal-year instead of a calendar-year basis in the excessive deficit procedure.

Table 5a Gross government debt in the EU-15 countries (per cent of GDP), 1997-2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Austria	64.6	**65.0**	**67.4**	66.7	**67.1**	66.7	65.4	65.2	64.4	64.1
Belgium	124.8	119.6	114.9	109.1	108.0	105.4	100.0	95.6	94.9	91.7
Finland	54.1	48.6	47.0	44.6	43.8	42.5	**45.3**	45.1	44.3	43.7
France	59.3	**59.5**	58.5	56.8	57.0	59.0	63.9	65.6	66.2	67.1
Germany	**61.0**	60.9	**61.2**	60.2	59.4	**60.9**	**64.2**	**66.0**	**68.0**	**68.9**
Greece	**114.0**	112.4	112.3	**114.0**	**114.8**	112.2	109.3	110.5	110.5	108.9
Ireland	64.7	53.7	48.7	38.3	35.8	32.6	32.0	29.9	29.8	29.6
Italy	120.5	116.7	115.5	111.2	110.7	108.0	106.3	105.8	105.6	**106.3**
Luxembourg	6.8	6.3	6.0	5.5	7.2	7.5	7.1	7.5	7.8	7.9
Netherlands	69.9	66.8	63.1	55.9	52.9	52.6	54.3	55.7	57.6	57.9
Portugal	59.1	55.0	54.3	53.3	55.9	58.5	**60.1**	**61.9**	**66.5**	**67.5**
Spain	66.6	64.6	63.1	61.1	57.8	55.0	51.4	48.9	46.5	44.2
Euro area	75.1	74.3	72.9	70.4	69.6	69.5	**70.8**	**71.3**	**71.7**	**71.9**
Denmark	65.7	61.2	57.7	52.3	47.8	47.2	44.7	42.7	40.5	38.2
Sweden	70.6	68.1	62.8	52.8	54.3	52.4	52.0	51.2	50.3	49.2
UK	50.6	47.5	45.0	42.0	38.8	38.3	39.7	41.6	41.9	42.5
EU-15	71.1	69.0	68.0	64.1	63.3	62.7	**64.3**	**64.7**	**65.0**	**65.1**

Notes: 2005 and 2006 values are estimates using data up to 16 March 2005. Cases where the debt ratio is above 60 per cent of GDP and not falling are shown in bold.

Source: *Statistical Annex of European Economy*, Spring 2005, European Commission.

In the case of Portugal, the excessive deficit procedure was initiated as it should in 2002 and the recorded deficit was brought down below three per cent of GDP in 2003 and 2004. As a consequence, the procedure against Portugal was closed in May 2004. This did not conform to the stipulations, as the debt ratio was over 60 per cent of GDP and forecast by the Commission to increase in 2004 and 2005. In addition, budget deficits in 2004 and 2005 were forecast to exceed the three-per-cent ceiling again. It was also clear that the 2002 and 2003 reductions of the deficit were due largely to one-off measures.[24]

[24] *Economic Forecasts*, Autumn 2004.

Table 5b Gross government debt in the new EU countries (per cent of GDP), 1997-2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Cyprus	-	59.6	59.9	59.9	**61.9**	**65.2**	**69.8**	**71.9**	69.1	66.6
Czech Republic	12.7	15.0	16.0	18.2	27.2	30.7	38.3	37.4	36.4	37.0
Estonia	6.3	5.6	6.0	4.7	4.4	5.3	5.3	4.9	4.3	4.0
Hungary	63.9	61.6	60.9	55.4	52.2	55.5	56.9	57.6	57.8	57.9
Latvia	11.1	9.8	12.6	12.9	14.9	14.1	14.4	14.4	14.0	14.3
Lithuania	15.8	16.8	23.0	23.8	22.9	22.4	21.4	19.7	21.2	20.9
Malta	48.1	53.1	56.8	57.0	**62.4**	**62.7**	**71.8**	**75.0**	**76.4**	**77.1**
Poland	-	-	40.1	36.8	36.7	41.2	45.4	43.6	46.8	47.6
Slovak Republic	33.0	34.0	47.2	49.9	48.7	43.3	42.6	43.6	44.2	44.9
Slovenia	-	23.6	24.9	27.4	28.1	29.5	29.4	29.4	30.2	30.4
EU-10	32.2	32.5	37.5	35.9	37.0	40.0	43.5	42.8	44.1	44.5

Notes: 2005 and 2006 values are estimates using data up to 16 March 2005. Cases where the debt ratio is above 60 per cent of GDP and not falling are shown in bold.

Source: *Statistical Annex of European Economy*, Spring 2005, European Commission.

The most problematic cases, and the ones that initiated the changes in the stability pact, are Germany and France. The excessive deficit procedures against these countries began according to the book in late 2002 and early 2003, respectively. The two countries were then given recommendations by the Ecofin Council to correct their excessive deficits by 2004. However, when the two countries failed to reduce deficits in line with the recommendations, the procedures were not continued as envisaged. Even though the Commission accepted to extend the deadlines for correcting the excessive deficits until 2005 (with reference to the additional budgetary effort required because of a more abrupt cyclical downturn in 2003 than expected), the decisions to give *notice* to the two countries (a necessary condition for later sanctions) to correct their excessive deficits were blocked in the Ecofin Council. Instead, the Council adopted conclusions which in effect amounted to new *recommendations*.[25]

The halting of the excessive deficit procedures against France and Germany was challenged by the Commission in the European Court of Justice.

[25] See, for example, CEPS (2004), *EMU after 5 Years* (2004) or Public Finances in EMU (2005) for more detailed reviews of the excessive deficit procedures against France and Germany.

The ruling of the Court in July 2004 annulled the Council conclusions because they were judged to interfere with the stipulated procedures according to the Treaty.[26] But more importantly, the ruling confirmed that the steps in the excessive deficit procedure are not "automatic". They are instead subject to discretionary political decision-making: new steps in the procedure cannot be taken unless there is a qualified majority in favour of them, even if they have been envisaged both in the Treaty and the stability pact. The decision of the Court led to a re-assessment by the Commission, which in a communication in December 2004 accepted that the deadline for correcting the excessive deficits had *de facto* been extended to 2005. The motivation given was that France and Germany "had reason to believe" that the extensions in the Council conclusions were legally valid.[27] The Commission also made the judgement that no further steps under the excessive procedure were required, as the two countries were "on track to correct their excessive budget deficits in 2005". These judgements were not, however, consistent with the Commission's own published forecasts in either the autumn of 2004 or the spring of 2005.[28] Moreover, these forecasts predicted that the debt ratios (which were above 60 per cent of GDP) would increase. It is obvious that the Commission chose a lax interpretation of the rules to avoid further political conflicts with France and Germany.

Greece represents a special case, as the large deficits in 1997–2003 did not become known until 2004, when there were large upward adjustments in earlier reported figures in connection with a change in government. Then an excessive deficit procedure was opened. Greece was first given a recommendation in July 2004 to correct its excessive deficit by 2005. When the country was judged not to take effective action, the country was given notice to correct the deficit (still under the old stability pact) in February 2005. However, the deadline for correction was extended until 2006 with the motivation that the excessive deficit was so large that the effort of eliminating it in a single year might prove economically costly.[29] The statistical misreporting that allowed the Greek breaches of the deficit ceiling to go unnoticed for so long has very clearly illustrated the weaknesses of statistical monitoring in the EU. Given the extent of breaches of the deficit criterion and the very high debt levels in Greece, the Council's extension of the deadline (*ex post* allowing *ten* years of deficits above three per cent of GDP) can hardly be judged to be consistent with the fiscal framework.

[26] *Judgement of the Court of Justice in Case C-27/04* (2004).
[27] European Commission (2004a).
[28] *Economic Forecasts* Autumn 2004 and Spring 2005.
[29] *Council Decision Giving Notice to Greece* (2005).

As concerns the new member states, excessive deficit procedures against those with deficits above the three-per-cent limit were started immediately after their accession in May 2004. Cyprus, the Czech Republic, Hungary, Malta, Poland and the Slovak Republic were all placed in the excessive deficit category by the Ecofin Council in July 2004 and given recommendations to correct their excessive deficits. The deadlines were set as late as 2008 for the Czech Republic, Hungary and the Slovak Republic, whereas it was set at 2007 for Poland. The extended deadlines were motivated by "the special circumstances" arising from the large deficits at the time of accession and "the ongoing structural shift to a modern service-oriented market economy accompanying the process of real convergence".[30] Cyprus and Malta, with debt levels above 60 per cent of GDP, which were increasing, received shorter deadlines. All the new member states with excessive deficits, except Hungary, have later been judged to comply with the prescribed fiscal adjustment paths. Hungary was given a new recommendation in 2005 to take stronger action and is (at the time of writing in October 2005) likely to receive yet another one.[31]

In 2005, new excessive deficit procedures have been opened against Portugal, Italy and the UK under the rules of the revised stability pact. These procedures are discussed in Section 5.1.

Early warning procedure

According to the *early warning procedure*, the Ecofin Council can issue an early warning to a member state that diverges significantly from its medium-term budgetary objective (or the adjustment path towards it) "in order to prevent the occurrence of an excessive deficit".[32] The Commission ha recommended such early warnings in four cases: Portugal and Germany (January 2002), France (November 2002) and Italy (April 2004). Only in one of these cases (France) did the Council issue a formal warning. In the other three, the Council did not heed the recommendation of the Commission and abstained from giving an early warning. Instead, the Council was satisfied with "informal commitments" by the countries concerned to avoid excessive deficits. These "commitments" were not credible *ex ante*. And since deficits were *ex post* found to be excessive, early warnings had indeed been justified. They would have been so also in the case of Greece, but there the issue of an early warning was never raised, despite doubts in

[30] See the respective Ecofin Council recommendations.

[31] In the case of non-compliance with the recommendation of the Ecofin Council, a country outside the eurozone cannot be given notice, but only a new recommendation. See Section 3.1.

[32] See Section 3.1.

Table 6a Breaches of deficit and debt criteria and the excessive deficit (ED) procedures for EU-15 countries, 1999-2005

France	Germany	Greece	Italy	Netherlands	Portugal 1	Portugal 2	UK
Deficits	Deficits	Deficits	Deficits	Deficits	Deficits	Deficits	Deficits
2002: 3.2 2003: 4.2 2004: 3.7 2005: 3.0	2002: 3.7 2003: 3.8 2004: 3.7 2005: 3.3	1999: 3.4 2000: 4.1 2001: 3.6 2002: 4.1 2003: 5.2 2004: 6.1 2005: 4.5	2003: 3.1 2004: 3.1 2005: 3.6	2003: 3.2	2002: 4.4	2005: 6.2	2003/04: 3.2 2004/05: 3.2 2005/06: 3.0
Debt	Debt	Debt	Debt	Debt	Debt	Debt	Debt
2003: 63.9 (+4.9) 2004: 65.6 (+1.7) 2005: 66.2 (+0.6)	2002: 60.9 (+1.5) 2003: 64.2 (+3.3) 2004: 66.0 (+1.8) 2005: 68.0 (+2.0)	2000: 114.0 (+1.7) 2001: 114.8 (+0.8) 2004: 110.5 (+1.2) 2005: 110.5 (±0)			2003: 60.1 (+1.6) 2004: 61.9 (+1.8)	2005: 66.5 (+4.6)	
• Commission report 02/04/03 • Commission opinion and recommendation 07/05/03 • Council decision on ED and recommendation to correct ED by 2004 03/06/03	• Commission report 19/11/02 • Commission opinion and recommendation 08/01/03 • Council decision on ED and recommendation to correct ED by 2004 21/01/03	• Commission report 19/05/04 • Commission opinion and recommendation 24/06/04 • Council decision on ED and recommendation to correct ED by 2005 05/07/04	• Commission report 07/06/05 • Commission opinion and recommendation 29/06/05 • Council decision on ED and recommendation to correct ED by 2007 28/07/05	• Commission report 28/04/04 • Commission opinion and recommendation 19/05/04 • Council decision on ED and recommendation to correct ED by 2005 02/06/04	• Commission report 24/09/02 • Commission opinion and recommendation 16/10/02 • Council decision on ED and recommendation to correct ED by 2003 05/11/02	• Commission report 22/06/05 • Commission opinion and recommendation 20/07/05 • Council decision on ED and recommendation to correct ED by 2008 12/09/05	• Commission report 28/04/04 • Commission report 21/09/05

• Commission judgement on lack of effective action 08/10/03 • Commission recommendation to give notice 21/10/03 • Council conclusions, instead of notice, to correct ED by 2005 25/11/03 • Court of Justice annulment of Council conclusions 13/07/04 • Commission communication on extended deadline until 2005 14/12/04	• Commission judgement on lack of effective action 18/11/03 • Commission recommendation to give notice 18/11/03 • Council conclusions, instead of notice, to correct ED by 2005 25/11/03 • Court of Justice annulment of Council conclusions 13/07/04 • Commission communication on extended deadline until 2005 14/12/04	• Commission judgement on lack of effective action 22/12/04 • Council decision on lack of effective action 18/01/05 • Commission recommendation to give notice 9/02/05 • Council decision to give notice and extend deadline until 2006 17/02/05		• Commission recommendation to close ED procedure 18/05/05	• Commission recommendation to close ED procedure 28/04/04 • Council decision to close ED procedure 11/05/04		

Notes: Deficit and debt figures are in per cent of GDP. Debt figures in parenthesis show the increases from previous year. For the UK, deficit figures refer to fiscal years, as the evaluations in the excessive deficit procedure for this country are made on this basis.

Table 6b Breaches of deficit and debt criteria and the excessive deficit (ED) procedures for EU-10 countries, 2004-2005

Cyprus	Czech Republic	Hungary	Malta	Poland	Slovak Republic
Deficits	Deficits	Deficits	Deficits	Deficits	Deficits
2004: 4.2	2004: 3.0 2005: 4.5	2004: 4.5 2005: 3.9	2004: 5.2 2005: 3.9	2004: 4.8 2005: 4.4	2004: 3.3 2005: 3.8
Debt	Debt	Debt	Debt	Debt	Debt
2004: 71.9 (+2.1)			2004: 75.0 (+3.2) 2005: 76.4 (+1.4)		
• Commission report 12/05/04 • Commission opinion and recommendation 24/06/04 • Council decision on ED and recommendation to halt increase in debt ratio in 2004 and reduce deficit below 3 per cent in 2005 05/07/04	• Commission report 12/05/04 • Commission opinion and recommendation 24/06/04 • Council decision on ED and recommendation to correct ED by 2008 05/07/04	• Commission report 12/05/04 • Commission opinion and recommendation 24/06/04 • Council decision on ED and recommendation to correct ED by 2008 05/07/04 • Council judgement on lack of effective action 22/12/04 • Council decision on lack of effective action 18/01/05 • New Commission re-commendation 16/02/05 • New Council re-commendation 08/03/05 • New Commission re-commendation 20/10/05	• Commission report 12/05/04 • Commission opinion and recommendation 24/06/04 • Council decision on ED and recommendation to halt increase in debt ratio in 2005 and reduce deficit below 3 per cent in 2006 05/07/04	• Commission report 12/05/04 • Commission opinion and recommendation 24/06/04 • Council decision on ED and recommendation to correct ED by 2007 05/07/04	• Commission report 12/05/04 • Commission opinion and recommendation 24/06/04 • Council decision on ED and recommendation to correct ED by 2008 05/07/04

Notes: Deficit and debt figures are in per cent of GDP. Debt figures in parenthesis show the increases from previous year.

the European Commission about the reliability of the country's fiscal statistics.[33]

Grave deviations from the stipulated procedures
The overall picture is thus one of weak enforcement of the earlier rules. The early warning procedure has not been used as it should. The excessive deficit procedure has been initiated according to the book in case of deficits above three per cent of GDP (except for the UK in 2004), but deviations from the stipulations regarding subsequent procedural steps have been notorious: this includes failures to give notice and impose sanctions (France and Germany), the setting of very long deadlines (France, Germany and Greece), unjustified closing of the excessive deficit procedure (Portugal) and neglect of the debt criterion (France, Germany, Greece and Portugal).

3.2.2 Effects on fiscal behaviour

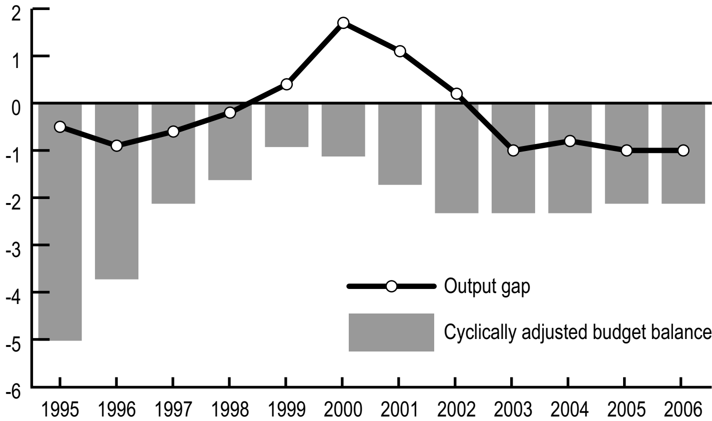
The previous section examined to what extent the formal rules and procedures have been observed. Another issue is to what extent the rules have influenced actual fiscal behaviour. This may, of course, have been the case even if fiscal policy did not fully conform to the formal stipulations.

As seen in Figure 1, there was indeed a major reduction in the aggregate budget deficit of EU-15 after the adoption of the Maastricht Treaty in 1992. The bulk of the adjustment was achieved in the mid 1990s when the fiscal rules served also as admittance criteria for the monetary union. Improvements in the budget balance between 1995 and 2000 were particularly large in Sweden (by 12.0 per cent of GDP), Finland (by 11.0 per cent of GDP), the UK (by 9.6 per cent of GDP), Italy (by 7.0 per cent of GDP), Ireland (by 6.5 per cent of GDP), the Netherlands (by 6.4 per cent of GDP) and Greece (by 6.1 per cent of GDP), as seen in Table 1. The reductions in actual budget deficits reflected major improvements in the cyclically adjusted budget balances (see Figure 3). The improvements in the budgetary situation halted the rise in the debt ratio for the EU-15 countries and led to a decline in the 1997–2002 period, as can be seen in Figure 2.

Budget deficits have returned to higher levels again in the growth slowdown from 2002: aggregate deficits for both the euro area and EU-15 have amounted to 2.5 per cent of GDP or more, as shown in Figure 1 and Table 3a. Partly this reflects the working of the automatic stabilisers, leading to lower tax revenues and higher government expenditure when output and

[33] See Public Finances in EMU (2005).

Figure 3 Cyclically adjusted budget balance and output gap (per cent of GDP) for EU-15, 1995-2006



Note: 2005 and 2006 values are estimates using data up to 16 March 2005.

Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

employment are low. But also the cyclically adjusted budget balances have deteriorated (see Figure 3 and Table 4). This could reflect discretionary fiscal policy to counter the downturn. But it is also a common view that there was too little fiscal consolidation in the 1998–2000 upswing: the improvement in the cyclically adjusted budget balance then was smaller than the subsequent deterioration. Indeed, the cyclically adjusted budget deficits for both the euro area and EU-15 deteriorated between 1999 and 2000. This has been interpreted as evidence of "fiscal consolidation fatigue" after the budgetary efforts associated with the start-up of the monetary union.[34]

A deeper analysis of how the EU rules have influenced fiscal behaviour requires econometric analysis checking for other factors that may affect budget outcomes. The typical research strategy is to estimate a fiscal policy reaction function, which seeks to explain (some measure of) the budget balance with factors such as the output gap (to capture the extent to which the budget balance responds to cyclical fluctuations), the level of government debt (to capture that the higher government debt, the stronger are the

[34] See, for example, *EMU after 5 years* or Public Finances in EMU (2005).

incentives for fiscal restraint), and past deficits (to capture policy inertia). One can then examine whether the reaction function has changed after the introduction of the EU fiscal policy framework and whether it differs systematically between EU (eurozone) countries and other countries.

A number of such empirical studies have been made. They do give some support for the hypothesis that the EU fiscal rules have indeed had an effect on fiscal behaviour.

1. Several studies have found that, under otherwise equal conditions, budget deficits seem systematically to be lower in the current eurozone countries after the introduction of the fiscal rules in the early 1990s than they were earlier (and they are in other OECD countries).[35] A couple of studies attribute this result to a larger sensitivity of the budget balance to debt levels.[36] Another study found that the introduction of the stability pact did indeed reduce the probability of deficits in excess of three per cent of GDP.[37]
2. A problem for these studies is when to date the introduction of the EU fiscal rules. Should it be dated back to 1992 when the Maastricht Treaty was adopted or should one choose a later date, for example, when the stability pact was adopted in 1997 (which was also the qualification year for first-round participation in the monetary union)? On the whole, the exact dating does not seem to matter much for the results. But there is some evidence that the largest effect of splitting observations in a pre-fiscal-rules and a fiscal-rules period is obtained if the split is made in the mid 1990s.[38] There is also some empirical evidence of a weakening of budgetary restraint in recent years, although observations are still too few to permit a thorough analysis of the most recent experiences.[39]
3. It does not appear that the EU fiscal rules have made fiscal policy less countercyclical. If anything, the effect seems to have been the reverse. Budget deficits appear to have increased more in response to negative output gaps and vice versa in the eurozone countries after the early and mid-1990s than earlier.[40] But there seems to have been a similar development also in non-eurozone countries both inside and outside the EU. There is some evidence, too, that discretionary fiscal policy "shocks" –

[35] See, for example, Formi and Momigliano (2004), Public Finances in EMU (2004), Hughes-Hallet, Lewis and von Hagen (2004), and Ballabriga and Martinez-Mongay (2005).
[36] Public Finances in EMU (2004) and Ballabriga and Martinez-Mongay (2005).
[37] Hughes-Hallet, Lewis and von Hagen (2004).
[38] Ballabriga and Martinez-Mongay (2005).
[39] Hughes-Hallet, Lewis and von Hagen (2004).
[40] See, for example, Galí and Perotti (2003) or Posen (2005).

that is policy changes unrelated to the cyclical situation – have become less frequent in the eurozone countries after the introduction of the fiscal rules.[41]

The upshot is that there is plenty to suggest that the imposition of the EU fiscal rules in the 1990s indeed had a disciplining effect on fiscal behaviour. This seems to have occurred without reducing the role of fiscal policy as a countercyclical policy tool. This points to the large risks associated with the weakening of the EU fiscal framework that has recently taken place.

3.3 The recent debate on the fiscal rules

Since their inception, the EU fiscal rules have been hotly debated. The debate has concerned both *economic contents* and *enforceability*. As regards the economic contents, one issue has been how instrumental the numerical targets and constraints are in avoiding socially undesirable debt accumulation. Another issue is to what extent the rules give rise to undesired *side effects*.

3.3.1 The instrumentality of the rules

A frequent criticism has been that the rules are *arbitrary* and lack a theoretical foundation.[42] This criticism has applied both to the medium-term objective of a budget "close to balance or in surplus" and to the deficit and debt ceilings. The critics have pointed out that there exists no commonly accepted theory of the optimum size of government debt. So, according to that argument, there is no theoretical justification for a policy leading to convergence of net government debt to zero (which is the long-term implication of a balanced budget over the cycle) or a positive net financial position of the government (which is the long-term implication of budget surpluses over the cycle). Nor is it possible in practice to conclude at what numerical value government debt becomes unsustainable. Instead, temporary debt accumulation may be socially optimal to the extent that it counteracts cyclical instability or reduces tax distortions by allowing taxes to be smoothed over time.

Myopic or backward-looking rules

A related argument criticises the rules for being *myopic* or even *backward-looking* instead of forward-looking.[43] Current accumulation of government

[41] Fatás and Mihov (2003).

[42] See, for example, Buiter, Corsetti and Roubini (1993) or Wyplosz (2002, 2005).

[43] See, for example, Buiter and Grafe (2004).

debt involves no sustainability problem to the extent that it can be paid for through future net income streams of the government. Similarly, low deficits and low government debt today do not guarantee fiscal sustainability if there are future high government expenditures (or low tax incomes), for example, because of demographic changes. Such considerations have motivated proposals on replacing the numerical targets and constraints with discretionary judgements made at the EU level by independent expert panels on the sustainability of fiscal policy.[44]

Definition of debt

Some of the critique has focused on the debt definitions in the EU rules. The debt concept refers to *gross* government debt, that is government debt after netting out claims and debts within the government sector. Hence, no account is taken of government claims on the private sector, which should be considered in order to assess properly the financial position of government. The use of the gross debt concept also opens up the possibility of reducing government debt, according to the definition in the rules, through purely financial transactions (using the proceeds from sales of financial claims on the private sector to pay off debt), which do not change the net financial position of the government.

Other problems relate to the exclusion of *contingent* government debt, in the form of implicit or explicit government guarantees of loans to private or state-owned firms, from the debt concept. A particularly important problem concerns *implicit pension debt*, which has been excluded from the debt definition in the fiscal rules. A similar argument applies in principle to all expenditures (as well as taxes and social insurance contributions) that are anticipated in the future: obviously there is a sliding scale from explicit government debt over various forms of implicit debt (expenditure obligations like pensions which any government will find it difficult not to honour) to expenditures – and taxes – that the government can change more or less at will.[45]

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[44] Pisani Ferry (2002), Fatás and Mihov (2003), and Eichengreen (2004) are examples of such proposals.

[45] Wyplosz (2005) and Franco, Marin and Zotteri (2005) discuss these issues further. The problem of what to include above the line arises already in calculations of implicit pension debt. Should one include only the present value of pensions to be paid in the future on the basis of accrued rights? Or should one also include future anticipated contributions of existing workers as well as the pension rights they are anticipated to earn? Should one include anticipated contributions and accruals of pension rights of future workers?

Inconsistency between debt and deficit stipulations
Yet another issue concerns the *consistency* between the debt and deficit stipulations in the rules. The debt ceiling refers to gross debt, whereas the budget deficit represents a change in the *net* debt of the government. Moreover, the change in the net government debt ratio does not depend on the deficit ratio only. Abstracting from valuation changes in government debt and discrepancies arising from differences in measurement practices between budget deficits and debts, it holds that:[46]

(*the change in net government debt as a share of GDP*) ≈ (*the budget deficit as a share of GDP*) – (*the initial government debt as a share of GDP*) × (*the growth rate of nominal GDP*),

where

(*the growth rate of nominal GDP*) ≈ (*the rate of real GDP growth*) + (*the rate of inflation defined as the rate of change of the GDP deflator*).

It follows that a given deficit ratio is consistent with a larger reduction (or a smaller increase) in the debt ratio, the higher is the growth rate of nominal GDP. As nominal GDP growth differs considerably among EU countries, a given deficit ratio thus gives rise to very different debt dynamics. Looking at the old EU countries, both lower real growth and lower inflation than in the early 1990s mean that a given deficit ratio causes convergence to a higher debt ratio than was earlier envisaged: with, say, potential growth of 1.5 per cent and 2 per cent inflation annually, a 3 per cent deficit ratio implies convergence towards a net debt ratio of 86 per cent, whereas the same deficit ratio implies convergence to a net debt ratio of 60 per cent with 2.5 per cent potential growth and 2.5 per cent inflation.[47]

For the new member states the situation is very different. They will have both higher real growth and higher inflation (the Balassa-Samuelson ef-

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[46] See, for example, Buiter, Corsetti and Roubini (1993), EEAG (2003) or ECB (2005) regarding the formula. Note that deficits are measured on an accruals basis, whereas debt is measured on a cash basis. This, together with pure measurement errors, valuation changes and financial transactions changing the difference between gross and net debt, gives rise to a so-called *stock-flow adjustment*, which explains why the change in gross debt usually deviates from the formula in the text (von Hagen and Wolff 2004 and Public Finances in EMU 2005).

[47] The debt ratio the economy converges to is obtained by setting the change in the debt ratio to zero in the first of the two above equations and solving for the debt ratio. The point that the potential growth rate has fallen in Western Europe has been argued by, for example, CEPS (2005).

fect)[48] than the EU-15 countries for a long period of time during which their income levels converge to Western European standards. This means that a given deficit ratio implies convergence towards much lower debt ratios in the new member states than in the old ones: for example, with 3.5 per cent real growth and 3.5 per cent inflation annually, the net debt ratio will converge towards only 43 per cent.[49]

Differentiation of targets and constraints

The differences among EU countries in forecast nominal GDP growth have been taken as an argument in favour of *differentiation* of budget targets among countries. One way of making such a differentiation is to take differences in potential growth into account, allowing countries with higher growth rates to run larger deficits and vice versa.[50]

The focus on deficits rather than on debt in the fiscal rules (with sanctions tied only to violations of the deficit, but not of the debt, criterion) has also been questioned. It has been argued that countries should be free to run any budget deficits they like (in order to achieve other policy objectives than long-run fiscal sustainability, as discussed in Section 3.3.2) provided that the debt ratio is below some critical level.[51] The motivation is that a main advantage of low debt levels (for governments as well as households and private firms) should be larger room to manoeuvre in the short run. On the other hand, the focus on deficits can be justified by their inertia (once deficits have arisen they usually take a long time to eliminate), which makes them a good predictor of future debt developments.[52] A possible compromise might be to relate the medium-term budget objective and the deficit ceiling to the debt ratio. A proposal along these lines was made by EEAG (2003) and Calmfors and Corsetti (2003), who suggested that

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[48] According to the Balassa-Samuelson effect, inflation is higher in low-income than in high-income countries (with the same currency or fixed exchange rates to each other) during a catching-up process. The explanation is that the higher growth in the catching-up countries is concentrated to the tradables sector. This leads to higher wage growth in this sector in the catching-up countries, which spreads to the non-tradables sector as well. As a consequence, prices of non-tradables increase faster in the catching-up than in the richer countries, and overall inflation therefore becomes higher. See, for example, EEAG (2002).

[49] In the examples above, I have thus assumed a difference in annual real growth rates between new and old EU states of 2 percentage points and a difference in inflation rates of 1.5 percentage points. See, for example, Buiter and Grafe (2004) for a discussion of appropriate assumptions.

[50] A *market mechanism* for differentiating deficit ceilings has been proposed by Casella (2001). According to the proposal, there would be a deficit ceiling for the eurozone as a whole. Each country could then bid for deficit permits in a similar way as firms can bid for emission permits under the Kyoto protocol.

[51] This has been done by, for example, Canzoneri and Diba (2001).

[52] von Hagen, Perotti and Hausmann (1998).

lower debt ratios should allow progressively higher deficit ceilings according to a well-defined scale.[53] An alternative set-up, according to which countries with low debt levels could be given longer time to correct excessive deficits after discretionary decisions by the Ecofin Council, was proposed by the European Commission (2004b). Relating maximum deficits to debt could also be seen as an indirect (and delayed) way of taking differences in potential growth rates into account, since fast-growing countries tend to converge on lower debt ratios than slow-growing countries.

Excessive government spending

A final argument sees excessive government spending rather than excessive deficits as the main problem. One basis for this view is that, according to the common-pool argument, a deficit bias is just a special case of excessive government spending.[54] It is well known that fiscal profligacy is associated mainly with rises in government expenditures in good times and that fiscal consolidation programmes tend to be more long-lasting the more expenditure-based they are.[55] According to this view, proper rules to promote fiscal discipline would impose spending limits rather than deficit and debt limits.[56] Indeed, expenditure ceilings were also suggested in the original German proposals on the stability pact.[57] The main argument against such expenditure rules at the EU level is the infringement on national sovereignty they might involve, as national preferences regarding the size of government spending seem to differ fundamentally.[58]

Conclusions

There is great diversity of opinion on the instrumentality of the EU fiscal rules. A pragmatic conclusion is that, despite our lack of knowledge of what levels of government debt are excessive or unsustainable, *prudential considerations* provide a strong case for numerical constraints on deficits and debt. These constraints are easy to communicate and understand. It is very difficult to make more sophisticated forward-looking rules operational: any such rules are bound to involve more or less arbitrary judge-

[53] Note, however, that the rate of reduction of the debt-to-GDP ratio in *percentage points* due to nominal GDP growth is, for arithmetical reasons, always larger the higher the initial debt ratio is, although the relative rate of reduction (the reduction in *per cent*) due to nominal growth is the same. This is clear from the first of the two equations in the text.

[54] Indeed, the argument was originally developed by Weingast, Shepsle and Johnsen (1981) for tax-financed government spending. See Section 2.2 above.

[55] See, for example, Alesina and Perotti (1995) and Public Finances in EMU (2003).

[56] Blanchard and Giavazzi (2004).

[57] See Stark (2001).

[58] See Calmfors *et al.* (1997).

ments on future developments.[59] Nor would it be possible to base sanctions on such discretionary judgements: sanctions would then almost certainly lack the legitimacy needed for credible enforcement.

If one wants to stick to simple numerical constraints for the same fiscal variables as now, it is difficult to find convincing arguments why other numerical values than the current ones would be more appropriate. There is indeed a strong case for keeping the three-per-cent deficit ceiling and the 60-per-cent debt ceiling in order to exploit the investment that has been made into making them well-known benchmarks for fiscal policy.[60] It is harder to build a theoretical case for why a balanced budget and convergence towards zero net debt is desirable in general. There is, however, a broad consensus on the need to accommodate future demographic strains on public finances in the EU countries. Even with balanced budgets, the future costs of ageing might cause fiscal sustainability problems in many EU countries.[61] Such considerations provide a strong *pragmatic* argument against a relaxation of the earlier medium-term objectives.

There would, however, be good reasons for conditioning the deficit ceiling on the debt level. There are also arguments for replacing gross debt with net debt as the debt concept in the rules. The original motivation for using gross debt was a fear that government claims on the private sector might be "soft" ones (loans to firms being hidden subsidies, for example). But completely excluding private-sector claims is probably a much larger distortion than the risk that soft loans would be counted if claims on the private sector were included.[62] The main problem with revising the debt concept is the risk that such a revision is used as an opportunity to loosen the debt criterion.

3.3.2 Undesired side effects of the fiscal rules

Much of the discussion of the EU fiscal rules has centred on the risks of *undesired side effects* (too little "flexibility" in the jargon used). The issues most discussed relate to (i) government investment; (ii) structural reforms; and (iii) the possibility to run temporary deficits for tax-smoothing or stabilisation reasons.

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[59] This applies, for example, to the *permanent balance rule* proposed by Buiter and Grafe (2004) to ensure government solvency. According to this rule, the government debt ratio is allowed to increase when current government expenditure or real interest rates are judged to be temporarily high or real growth to be temporarily low.
[60] See also EEAG (2003).
[61] See, for example, Public Finances in EMU (2004, 2005) or EEAG (2003, 2005).
[62] See also Wyplosz (2005).

Government investment
One of the most frequently voiced objections against the EU fiscal rules concerns government investment. The main argument is that the sustainability of government finances is not related to the *financial* position of the government, but to its *net wealth*, including physical capital assets: a budget deficit which is used to finance government investment yielding future tax incomes does not represent a future burden on government finances.

The criticism has been that the fiscal rules lead to inefficiently low government investment by not allowing investment costs to be distributed over time.[63] The critics have pointed to a decline in government investment as a share of GDP in the eurozone after the adoption of the fiscal rules. This decline can be seen in Table 7. But the picture is not so clear. The reduction in government investment in the eurozone in the 1990s was a continuation of a long-run trend, which also occurred in other countries. The particularly large fall in government investment from 1990–94 to 1995–99 was a universal phenomenon. Moreover, the reduction was larger in the three old EU countries outside the eurozone (Denmark, Sweden and the UK) than in the eurozone countries, where the fiscal rules have been perceived as more binding. A stronger case for adverse effects of rules of the EU type on government investment is provided by research on US state budgets, which indeed indicates that pay-as-you-go constraints on the financing of capital projects reduce capital spending.[64]

The accession of the new member states to the EU has put more focus on the government investment issue, as the government (as well as the private) capital stock is smaller in these countries and expected returns on investment therefore higher than in the old EU countries.[65] Table 7 shows that government investment as a share of GDP has been substantially higher in the new member states than in the old ones.

A number of proposals on various so-called *golden rules* that would allow deficit financing of capital expenditure have been made. A recent example is Blanchard and Giavazzi (2004). They proposed that the medium-term objective of a (roughly) balanced budget should be replaced by a stipulation that only current spending, including capital maintenance and depreciation costs, be balanced. Such a rule would imply that government *net wealth*, instead of government net debt, converges to zero in the long run.

[63] Blanchard and Giavazzi (2004) is a recent example of such criticism.
[64] Poterba (1996).
[65] See, for example, Buiter and Grafe (2004) and Calmfors (2004),

Table 7 Gross government investment (per cent of GDP), 1970-2004

	1970-74	1975-79	1980-84	1985-89	1990-94	1995-99	2000-04
Eurozone	3.8	3.5	3.3	3.1	3.1	2.6	2.5
EU-3	5.0	3.9	2.7	2.4	2.6	1.9	1.7
EU-6	-	-	-	-	-	3.7	3.3
US	3.7	3.5	3.5	3.8	3.5	3.1	3.2
Australia	4.0	4.1	3.0	3.1	2.7	2.4	2.3
Canada	3.9	3.3	3.0	2.8	2.9	2.4	2.5
Japan	5.2	5.7	5.5	4.8	5.5	5.9	4.5
Norway	4.6	4.6	3.3	3.6	3.5	3.3	2.8
Switzerland	-	-	-	-	3.6	2.9	2.6

Notes: EU-3 is Denmark, Sweden and the UK. EU-6 is the Czech Republic, Estonia, Latvia, Lithuania, Poland and the Slovak Republic.

Sources: OECD database and *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005.

The government debt-to-GDP ratio would then converge towards the ratio of government capital to GDP, so that ultimately all government debt would be backed by government capital. In this situation, the government can run a deficit equal to the capital stock times the (nominal) growth rate. Such a rule would be similar to the national fiscal rule in the UK according to which the government budget deficit must not exceed net capital formation over the business cycle.[66] A golden rule was discussed before the drawing-up of the Maastricht Treaty. It is reflected in the formulation in the Treaty that the Commission shall, when preparing a report on whether there is an excessive deficit in a member state, "take into account whether the government deficit exceeds government investment expenditure", although this stipulation has not – so far – had much practical significance.

A number of counter arguments against a golden rule have been put forward.[67] One argument is that many types of government investment do not give financial returns. With a golden rule, such investment would have to be identified *ex ante*, which is difficult. Another argument is that debt financing of government investment would open up even more possibilities for *creative accounting* than today, as current expenditures could be reclassified as capital expenditures. A third argument concerns the allocation

[66] See, for example, Buiter (2001).
[67] See, for example, EEAG (2003).

between human capital investment (education) and physical capital investment: the current rules may reduce both human and physical capital investment below the socially efficient levels, but eliminating the physical capital distortion could aggravate the human capital one: there would be an incentive to substitute physical capital investment for human capital investment in an inefficient way. And if one tries to correct this problem by extending the golden rule also to human capital investment, the risk that current expenditure is misclassified as capital investment increases.

Obviously, there would be both gains and losses from adopting a golden rule. The gains would be larger for the new EU member states in their present catching-up phase than for the old, as the need for physical capital investment is larger in the former group. One proposal that takes this into account is Calmfors (2004), who suggests that a golden rule should be applied only for countries with a GDP per capita below some threshold (say that all government investment expenditure exceeding two per cent of GDP should be deducted from the deficit when the EU rules are applied, if GDP per capita is below 80 per cent of the EU average). This proposal would strike a balance between the risk that a golden rule is misused and the distortions from too low investment, since the golden-rule provision would only apply to the new member states for a limited period of time during which they catch up.

Structural reform

The argument for exempting government investment from the deficit rule has recently been extended also to *structural reforms*, that is to institutional reforms designed to improve the functioning of labour and product markets or the government sector.[68] The claim is that such reforms may increase future net government revenues (either by raising potential output, and hence the tax base, or by reducing government expenditures), but have short-term financial costs in much the same way as government investment. These short-term costs can arise for several reasons.[69] For example, re-directing part of pension contributions away from paying the pensions of the current retirees to establish a funded "pillar" of the pension system involves a direct short-term financial cost for the government, but reduces its future pension obligations. There could also be indirect costs, because large groups of employees may have to be compensated financially if they are to accept labour market reforms (for example less employment protection or lower minimum wages). Or it may just be that some structural re-

[68] See, for example, European Commission (2004b) or Beetsma and Debrun (2005).
[69] See Public Finances in the EMU (2005) for a more complete discussion.

forms use up so much "political capital" of a government that there is not enough left for fiscal consolidation.

The structural-reform argument is thus similar to the golden-rule argument for government investment. Structural reforms are viewed as "investment expenditure" yielding future financial returns. Without specific provisions for such reforms, there will, according to this argument, be too little structural reform.[70]

How should the argument be evaluated? The problem is that there are many types of structural reforms. Some of them, for example reductions in unemployment or pension benefits, already have positive budget effects in the short run. So, one cannot claim that structural reforms in general imply a short-run deterioration in government finances. And when this is the case, the uncertainty regarding future revenues – for example with many labour market reforms – is often very large. A recent study by the Commission fails to find compelling evidence that structural reforms in the EU countries have been associated with increases in deficits (except possibly labour market reforms).[71] Nor does this study suggest that reforms have been less frequent in years with budgetary consolidation or that, after controlling for other factors, the frequency of reforms has fallen after the introduction of the EU fiscal framework. The argument that structural reforms imply short-run budgetary costs also goes against the common observation that labour market reforms are often made in response, not to labour market problems, but to acute budget pressures.[72] Typical examples are Sweden in the 1990s as well as Germany, and possibly also France, in recent years.

Temporary deficits for tax-smoothing or cyclical reasons
Yet another criticism of the EU rules has been that they do not allow fiscal deficits as an optimal response to macroeconomic disturbances.[73] According to the *tax-smoothing* argument, temporary deficits are an optimal response to "necessary" temporary increases in government expenditure associated with, say, natural disasters, wars or other political upheavals, because tax distortions are minimised if (marginal) tax rates are held constant over time.[74] This criticism is, however, questionable, as one of

[70] Beetsma and Debrun (2005) has modelled this outcome explicitly.
[71] Public Finances in EMU (2005),
[72] See EEAG (2004).
[73] See in particular Eichengreen and Wyplosz (1998) or Wyplosz (2002, 2005).
[74] The original argument is due to Barro (1979).

the motives behind the medium-term fiscal objective of a budget "close to balance or in surplus" is to provide room for temporary deficits in case of disturbances. In addition, the exceptionality clause that a deficit larger than three per cent of GDP is permitted if it is the result of "an unusual event outside the control of the Member State concerned and has a major impact of the financial position of the general government" gives room for such tax smoothing in the case of extraordinary events.

The most common argument in favour of temporary fiscal deficits is, however, the "Keynesian" one that they may be needed for *cyclical stabilisation*. This need is larger for the eurozone countries than for other EU countries, as the former no longer have access to national monetary policy to offset country-specific macroeconomic shocks.[75] One option might be to formulate the deficit ceiling in cyclically adjusted terms. A counter argument is again that the medium-term objective of a budget "close to balance or in surplus" should provide enough leeway: it should allow both the automatic stabilisers to work and some discretionary action to be taken in downturns.[76] In addition, the "severe economic downturn" exemption provides additional room of manoeuvre. Another counter argument is that it would not be possible to base sanctions on cyclically adjusted deficits, as such calculations can be made in many different ways.[77] Finally, one could also maintain that large deficits in situations when government debt is already large may not raise aggregate demand because of Ricardian effects (when the general public debate focuses on fiscal sustainability problems, households are likely to realise that current tax reductions will have to be paid through tax increases in the near future and therefore to save more instead of raising consumption).[78]

3.3.3 Enforcement

A completely different type of criticism of the EU fiscal rules has concerned *enforceability*. The argument – which has proved correct – is that the rules are difficult, and perhaps even impossible, to enforce.[79]

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[75] See, for example, Calmfors *et al.* (1997), Swedish Government Commission on Stabilisation Policy in the EMU (2002), *HM Treasury* (2003), EEAG (2003) or Calmfors (2003a,b).

[76] See, for example, Buti and Giudice (2002) or Buti and Franco (2005). Indeed, as discussed in Section 3.2.2, empirical evidence does not suggest that fiscal policy in the EU countries has become less countercyclical after the introduction of the common fiscal rules. Rather, the reverse seems to hold.

[77] See EEAG (2003).

[78] See in particular Giavazzi and Pagano (1990, 1996).

[79] See Section 3.2.1 above.

Weak incentives for fiscal restraint in upswings

A first argument has to do with the incentives for fiscal responsibility in various phases of the business cycle. The main cause of large deficits in downturns is usually insufficient fiscal restraint in upswings. Indeed, as discussed in Section 3.2.2, many EU countries did not tighten fiscal policy enough in 1999–2000. It has been argued that the rules do not provide enough incentives for fiscal restraint in a boom, as there is no immediate reward for such behaviour.[80] The reward is instead the deferred one that the risk of breaching the three-per-cent deficit ceiling in future downturns is reduced. But there is a high probability that this reward will benefit another government than the incumbent one (or at least other members of the government than the current ones). So, just as the possibility of a change in government may cause a deficit bias, because it raises the effective discount rate of the current government,[81] it can also weaken the bite of the fiscal rules in booms. To address this problem, one would need either rewards or sanctions that are triggered also in booms if fiscal policy is then not tightened enough. The EEAG (2003) and Calmfors-Corsetti (2003) proposals on a link between the deficit ceiling and the debt level represents a (weak) way of providing an immediate and visible gain from fiscal discipline in upswings: it allows a government that reduces its debt to show the electorate that it has succeeded in moving up the country to a category with a larger permitted deficit and thus presumably "higher prestige".

Discretionary political decision-making

The primary cause of the enforcement problem is that the ultimate threat of sanctions is not *credible*.[82] The main reason is that the various steps in the excessive deficit procedure are not automatic, but instead subject to discretionary decision-making. This is in fact a deviation from the original German proposals on the stability pact in 1995/96, which very much stressed the importance of *automatic* sanctions.[83] The right of the Ecofin Council to take a discretionary decision not to follow the steps in the ex-

[80] The most commonly quoted formulation of the argument is Bean (1998).

[81] See Section 2.2.

[82] In the terminology of game theory, an equilibrium with low deficits is not *subgame perfect*, that is, if there are "defections" from this equilibrium by some player(s), the *ex ante* strategies of the other players to punish this behaviour are not *ex post* in their interest to carry out.

[83] See Stark (2001) and Costello (2001). The German proposal was that deficits above three per cent of GDP would automatically lead to sanctions. Such deficits would only be permitted with the approval of a qualified majority in the Ecofin Council and only in extreme cases. One reason for the rejection of the proposal was that automatic sanctions were re-

cessive deficit procedure as envisaged in the Treaty and the stability pact was indeed recognised by the European Court of Justice in its 2004 ruling regarding the application of the excessive deficit procedure to France and Germany.[84]

There are a number of reasons why the Ecofin Council is likely under discretionary decision-making to shun from sanctions.

A first reason is that member states threatened by sanctions have much stronger incentives to fight them than the other member states have to uphold them. There is a large political (and also pecuniary) loss for the member state being exposed to fines, but only a small gain for each of the other countries. The reasoning is similar to the argument that excessive government spending and deficits arise because interest groups, benefiting from specific expenditure programmes, have strong incentives to lobby for them, whereas taxpayers in general have only weak incentives to organise in order to lobby against.[85] The incentive to lobby against the application of the common rules are stronger for large than for small countries, as the former are less dependent on international rules to assert their interests. This conclusion is consistent with the fact that the large EU countries (France, Germany and Italy) have violated the rules more frequently and lobbied more intensively against them than the small countries.[86]

A second reason why the Council is likely to abstain from sanctions is *collusion* among finance ministers. Countries with large deficits have a common interest in forming coalitions in order to avoid sanctions. The fiscal rules seem to have been written under the assumption that violations would be rare and only involve one or two countries at a time. But once a situation arises where there are many violators, they have a strong incentive to

garded as incompatible with the discretionary decision-making procedure set out in the Maastricht Treaty. In the end, the German proposal was opposed by the other member countries, although there was initially strong support for it from both France and some small countries, including the Scandinavian ones, *inter alia* because of its "circumvention of political decision-making", according to the account in Stark (2001).

[84] See Section 3.2.1 above.

[85] See Section 2.2 above.

[86] The difference in behaviour between small and large EU states is further discussed by Buti and Pench (2004). They also emphasise that fiscal policy is more effective in influencing aggregate output in large and less open economies because of smaller import leakages. Small open economies instead have a stronger incentive to raise output and employment through structural reform lowering real wage costs, and thus depreciating the real exchange rate, as this has a larger expenditure-switching effect the more open the economy is. However, one could also argue that the large eurozone countries should be more inclined to observe the rules than the small ones because they have a greater influence on the eurozone aggregates and thus smaller possibilities to free ride.

collude. This is very clear from recent experiences. When the ongoing excessive deficit procedures against France and Germany were put on hold in late 2003, Germany supported France and vice versa. In addition, the two countries were supported by Portugal (which then also had an excessive deficit), Italy (which later proved to have already exceeded the deficit ceiling from 2003) and the UK (also above the deficit ceiling in 2003/04) as well as by Ireland and Luxembourg.[87] Italy was very clearly rewarded by France and Germany for its earlier support of them, when the Council did not heed the recommendation of the Commission to give it an early warning in 2004.[88] So was Portugal, for which the excessive deficit procedure was closed in 2004 despite continued violations of the debt criterion and clear signs that the improvement in the budget balance in 2003 and 2004 was only temporary.[89]

To limit collusion among "sinners", countries with excessive deficits should not be allowed to vote in the excessive deficit procedure for other countries. However, there are also strong strategic reasons for finance ministers in countries without large deficits to collude with the violators in order to avoid sanctions against the latter: since each minister knows that he/she might end up in a similar situation in the future, leniency against current violators can be seen as an "investment" in lenient future treatment of oneself.

Finally, the ministers in the Ecofin Council also have strong incentives to avoid political conflicts among member states. Enforcing sanctions are likely to cause such conflicts, which would go against the very aim of European co-operation and could seriously weaken support for the EU in the member state exposed to sanctions.[90] On the one hand, the desire to avoid international conflicts provides an incentive to follow internationally agreed rules, but, on the other hand, the same desire also provides an incentive *not* to enforce the rules through sanctions in case of violations.[91] This is the reason why international economic agreements are often policed by international "technocratic" bodies (IMF, WTO *etc.)* rather than by the countries that are party to the agreements.

[87] See CEPS (2004) as well as the discussion above in Section 3.2.1.
[88] See Section 3.2.1.
[89] Note, however, that the closing of the excessive deficit procedure against Portugal was, at least formally, on the recommendation of the Commission. In the case of the UK, the Commission never recommended the excessive deficit procedure to be started. See also Section 3.2.1 above.
[90] This point has been made by, for example, Uhlig (2002).
[91] See Section 2.2 above.

Table 8 The size of deposits/fines

Deficit (per cent of GDP)	Deposit/fine (per cent of GDP) Year 1	Subsequent years
3-4	0.3	0.1
4-5	0.4	0.2
5-6	0.5	0.3
6-7	0.5	0.4
7-	0.5	0.5

A main problem with the enforcement of the EU fiscal rules is that the excessive deficit procedure has been set up as a judicial process administered by politicians.[92] The judicial character of the process is revealed by the terminology of “corrective action”, “sanctions”, “fines” *etc*. For the reasons elaborated above, the threat that sanctions will be applied under political decision-making is not credible. A contributing factor could be that sanctions are too drastic. The objective of heavy sanctions is to deter undesirable behaviour, but if the sanctions are too draconian, political decision makers will never dare employ them. For this reason, Lindbeck and Niepelt (2005) have argued in favour of a continuous scale of sanctions rather than the discontinuous application of sanctions once the three-per-cent deficit ceiling is exceeded.

A peculiar feature of the EU fiscal rules is that deposits/fines are *front-loaded*: as long as deficits are below seven per cent of GDP, the deposit/fine is larger in the first year (which is the only one when payment of the fixed amount of 0.2 per cent of GDP is required) than in subsequent years (when only payment of the variable amount of 0.1 per cent of GDP is required), as can be seen from Table 8.[93] It might be easier to impose deposits/fines if they were smaller to begin with and then increased gradually over time instead.

The judicial character of the excessive deficit procedure is also likely to deter political decision makers from applying it rigorously, as it involves taking a decision that a member state has committed “an offence”. It would be better to regard the sanctions as fees (taxes) to *discourage* undesirable behaviour rather than as fines to *punish* breaches of the rules.

[92] See Calmfors (2004) and EEAG (2005) for an elaboration of this point.
[93] See Section 3.1 above.

The rules should in other words be interpreted in a more economic than legislative sense.[94] This would serve to make the rules more "flexible" by clarifying that a country may exceed the deficit ceiling, but that it can do so only at a cost.

With political decision-making on sanctions, the upshot is that these must be designed so that policy makers find it in their interest to apply them in the case of persistent violations of the rules. The alternative would be to *depoliticise* the decision process. The obvious choice would be to move the decisions on sanctions from the political to the judicial sphere, that is to the European Court of Justice, as was proposed by EEAG (2003) and Calmfors and Corsetti (2003). Judges – who make their career by upholding rules – have much stronger incentives to enforce the fiscal rules than politicians whose primary objective is to seek re-election.

Legitimacy

The ultimate guarantee for enforcement is that the rule itself, the enforcement procedure and sanctions are regarded as *legitimate* by the general public. Obtaining such legitimacy involves delicate trade-offs. On the one hand, a legitimate rule must probably be simple. This facilitates the verification of violations. Complex rules – with many contingencies – will not be well understood by the general public. On the other hand, any simple rule is exposed to the criticism that it does not duly consider all relevant aspects: the simpler the rule is, the easier it can be questioned for being arbitrary and not aligned with the ultimate objectives of economic policy.[95]

If a simple fiscal rule is to maintain its legitimacy, at least one of the following requirements must be met: (i) a strong memory in the public mind of deficit problems in the past; (ii) a strong perception among the general public of deficit problems likely to arise in the future in the absence of the rule; or (iii) repeated strong backing from politicians. In the case of the EU fiscal rules, none of these requirements has been met in recent years. Past deficit problems are no longer in strong memory in most countries. Future sustainability problems due to ageing societies may still be too far-off and abstract. Politicians, especially in France, Germany and Italy, have repeatedly undermined the legitimacy of the rules by attributing their own failures to rigid EU rules. Under such conditions, one should not be sur-

[94] This point has been made in particular by Lindbeck and Niepelt (2005). They argue in favour of continuous "Pigouvian taxes" in order to address the "externality problem" of large deficits within the monetary union. See also Calmfors (2005a) and EEAG (2005).

[95] As is well known, this is a major problem for exchange rate pegs designed to promote price stability.

prised that the forces to weaken the rules-based system turned out to be very strong in the end.

By making the original rules very simple, they became vulnerable to criticism for arbitrariness. As a consequence, the rules never acquired sufficient legitimacy to withstand opportunistic political attempts to revise them when this was regarded as politically expedient. Still, the process that has occurred may not have been unavoidable. There is also an element of bad luck. If Germany had not been among the first violators of the rules, it might have been possible to uphold them. And if Portugal had not corrected its excessive deficit in 2002-04 and had then been fined, a precedent might have been set that would have made it difficult for the large countries later to evade sanctions.

Another important consideration concerns the legitimacy of enforcement in general at the EU level. The debates on the proposed Constitution have revealed scepticism against far-reaching integration among large segments of the population in many EU countries. Also, it may not be clear to many citizens – nor to all economists – why fiscal profligacy is a problem for other EU countries and not only for the country concerned. It is revealing that the arguments on how government debt accumulation in some countries could increase the risk of inflation throughout the eurozone, which were so prominent in Germany before the start of the EMU, have been almost entirely absent from the public debate in recent years.

A final problem has to do with the legitimacy of the sanctions themselves. Even though the fines are limited in size, many people may have a problem with sanctions that exacerbate the deficit problem they are supposed to solve. One could argue that a fine, increasing the size of an excessive deficit even further, is not the best sanction. This is an argument for finding other, non-pecuniary sanctions. One possibility might be to let countries with persistent excessive deficits gradually lose some of their voting power (on all issues) in the Ecofin Council. However, such a sanction could raise other problems: for example, the legitimacy of decisions taken when a country is without full voting rights might be reduced.

Box 1: Why was the stability pact watered down?

The March 2005 reform of the stability pact was an *ex-post* adjustment to the breakdown of the pact's enforcement mechanism in November 2003 when the excessive deficit procedures against France and Germany were put on hold. The analyses in Sections 3.2.1 and 3.3 help identify a number of reasons why the original rules were not sustainable.

- Weak incentives for fiscal restraint in cyclical upswings, which led to excessive deficits in downturns.
- Sanctions were not made automatic as in the original German proposals for a stability pact in 1995/96, but instead subject to discretionary political decision-making involving weak incentives to actually employ the envisaged sanctions:
  - Strong temptation for countries which have large deficits simultaneously to collude, when voting in the Ecofin Council, to avoid sanctions.
  - Lenient treatment of a violator of the rules can be seen as an "investment" increasing the probability of oneself obtaining a lenient treatment in the case of own violations in the future.
  - A desire to avoid political conflicts among member states in general.
  - The front-loaded character of deposits and fines (larger in the first than in subsequent years) makes them hard to trigger (an "atomic bomb").
- Weak legitimacy of the rules.
  - Vulnerability of the rules to political attack because of their simplicity and the lack of sufficient contingencies.
  - Lack of legitimacy for the EU as an external enforcer, partly because it is not clear to the general public why fiscal deficits in one member state are a problem for others.
  - Problems to explain why pecuniary sanctions, worsening fiscal deficits, are an appropriate way of addressing a deficit problem.
- "Bad luck".
  - Worsening of fiscal outcomes associated with a reduction in potential growth.
  - Simultaneous deficit problems in several large countries coupled with a lack of tradition for small countries to form coalitions against the large ones.
  - Deficit problems in Germany – the "owner" of the stability pact – before a precedent of strict application had been set.
  - Lack of "statesmanship" among leading politicians in France, Germany and Italy.
- Insufficient monitoring of statistical reporting.
  - Discussion of statistical reporting within too narrow a circle of technical experts.

4 THE 2005 REFORM OF THE FISCAL RULES

The revisions of the EU fiscal rules in March 2005 encompassed both the preventive and the corrective arms of the stability pact. Most of the revisions have been included in two new Council Regulations on the pact (1055/2005 and 1056/2005), which amend the two earlier Regulations (1466/97 and 1467/97); other parts are only included in the report from the Ecofin Council, which set out the agreement among finance ministers (Ecofin Report 7423/2005). The revisions in total amount to a radical watering-down of the incentives for fiscal restraint. However, it has been pointed out that not all the changes are to this effect.[96] An evaluation of how much the rules have been loosened requires a detailed analysis distinguishing between the "soft" and "hard" ends of the stability pact. In such an evaluation, it is again helpful to distinguish between the economic contents of the rules and the enforcement possibilities.

4.1 The changes in the economic contents of the stability pact

Section 4.1.1 below reviews the changes in the economic contents of the stability pact and Section 4.1.2 evaluates the likely consequences.

4.1.1 A review of the changes

Excessive deficit procedure

The changes in the stability pact that have received the most attention are those in the excessive deficit procedure.

1. A first change concerns the definition of "a severe economic downturn", which could justify that a deficit above three per cent of GDP is not regarded as "excessive".[97] According to the original stability pact, an annual GDP fall of more than two per cent was automatically regarded as a "severe" downturn and a fall of more than 0.75 per cent *could* (after a discretionary decision by the Ecofin Council) be regarded as one. The exceptionality clause is now widened. According to the new Regulation on the excessive deficit procedure (Regulation 1056/2005), it is now enough with *negative growth* for the clause to apply. It will also apply if there is "an accumulated loss of output during a protracted period of very low growth relative to potential growth", that is if a large negative output gap (a gap between potential and actual output) devel-

[96] This point has been made in, for example, Public Finances in EMU (2005), Buti and Franco (2005), Buti, Eijffinger and Franco (2005), and ECB (2005).

[97] See Section 3.1.

ops over a number of years without any need for negative growth in a single year.

2. According to the original stability pact, the Commission should also "take into account all other relevant factors" when preparing a report that could form the basis for initiating the excessive deficit procedure against a member state.[98] The most important revision concerns this stipulation. In the Regulation from 1997 (Regulation 1467/1997), the "other relevant factors" are not specified. In the new Regulation on the excessive deficit procedure, it is explicitly stated that the Commission report should reflect factors such as "potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster R&D and innovation" as well as "fiscal consolidation efforts in 'good times', debt sustainability, public investment and the overall quality of public finances". In addition, consideration should be given to "any other factors which, *in the opinion of the Member State concerned* (italics added) are relevant in order to comprehensively assess in qualitative terms the excess over the reference value". These "other factors" are exemplified with "budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe if it has a detrimental effect on the growth and fiscal burden of a Member State".
3. The Ecofin Report, but not the new Regulation, recalls that there is both a deficit and debt criterion in the excessive deficit procedure and points out that increased emphasis should be given to the debt criterion. More specifically, the Council calls for an application "in qualitative terms" of the requirement that a debt ratio above 60 per cent of GDP should be "sufficiently diminishing and approaching the reference value" and for greater efforts to reduce debt levels, the higher they are.

Preventive arm

Other changes concern the preventive arm of the stability pact.

1. The medium-term fiscal objective, that is the objective for the cyclically adjusted budget balance, is now differentiated among member states. When setting the precise objective, account should, according to the new Regulation on the preventive arm (Regulation 1055/2005), be taken of "the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, also in

[98] See Section 3.1.

face of prospective demographic changes". The report of the Ecofin Council singles out the current debt ratio and potential growth as particularly important factors. For eurozone and ERM-2[99] member states, the country-specific medium-term objectives shall, according to the new Regulation, "be specified within a defined range between –1 % of GDP and balance or surplus, in cyclically adjusted terms, net of one-off and temporary measures". The budgetary objectives "shall provide a safety margin with respect to the 3 % GDP government deficit ratio", "they shall ensure rapid progress towards sustainability", and "they shall allow room for budgetary manoeuvre, considering in particular the needs for public investment". The report of the Ecofin Council also makes it clear that one should in the future – as soon as methods have been agreed – take "implicit liabilities (related to increasing expenditures in the light of ageing populations)" into account when setting the medium-term objectives.

2. For member states that have failed to reach their medium-term objectives, a "minimum annual adjustment" of "the cyclically adjusted balance, net of one-off and other temporary measures" will, according to Regulation 1055/2005, be required in the future. The benchmark for this minimum adjustment is 0.5 per cent of GDP. Adjustments should be larger than the benchmark in upswings, whereas they can be smaller in downturns.
3. Both the report of the Ecofin Council and the new Regulation on the preventive arm also contain a general "commitment" of member states to conduct more symmetric fiscal policies over the cycle. This should, according to the new Regulation, be achieved through "enhanced budgetary discipline in economic good times" with "the objective to avoid pro-cyclical policies".

Structural reforms

According to the revision of the stability pact, structural reforms should be taken into account in both the preventive and corrective arms of the pact. Structural reforms could justify both a slower adjustment path to the medium-term fiscal objective for countries that have not reached it and a temporary deviation for those countries that have, provided that the reforms are major and have "a verifiable impact on the long-term sustain-

[99] ERM (the Exchange Rate Mechanism) is an arrangement to limit exchange rate movements among participants. The original ERM was transformed into ERM-2 after the start of the monetary union. ERM-2 is now made up of the eurozone, Cyprus, Denmark, Estonia, Latvia, Lithuania, Malta and Slovenia.

ability of public finances". The Regulation on the preventive arm (1055/2005) refers to structural reforms in general, but also singles out reform of the pension system, introducing a mandatory funded component, in particular.[100] The provisions regarding the excessive deficit procedure are more restrictive and apply only to the introduction of a mandatory funded pillar of the pension system: the net costs of that shall, according to the revised Regulation, be taken into account during a five-year period (with deductions from the deficit ceiling gradually decreasing over time).

4.1.2 An evaluation of the changes in economic contents

At face value, some changes in the economic contents of the rules tend obviously to weaken fiscal discipline, whereas others rather strengthen it. But a proper evaluation must consider to what extent the revisions apply to the "hard rules" in the excessive deficit procedure (which are – still – backed by the ultimate threat of sanctions) or to the "soft rules" governing multilateral surveillance (where no sanctions exist). Making these considerations, it is obvious that the changes in the economic contents of the stability pact imply a major weakening of the incentives for fiscal discipline.

Other relevant factors

The most significant loosening of the pact is related to the specification of "the other relevant factors" that should be taken into account in the evaluation of whether a deficit is excessive.[101] It is true that some of the factors enumerated could allow for a more stringent treatment of deficits, as has been claimed by the Commission.[102] These factors include "potential growth", "fiscal consolidation efforts in good times" and "debt sustainability". However, other factors enumerated certainly open up for a more permissive attitude towards deficits. These include "policies in the context of the Lisbon agenda", that is various structural reforms, "policies to foster R&D and innovation" as well as "public investment".

The most far-reaching stipulation is that account should be taken of any other factors that a state with a large deficit deems important. The examples in the new Regulation on the excessive deficit procedure can obviously be given a wide interpretation.[103] "Budgetary efforts towards increasing or maintaining a high level of financial contributions to fostering international solidarity" could arguably include both development aid and defence

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[100] See the earlier discussion on structural reform in Section 3.3.2.
[101] See Section 4.1.1. above.
[102] See, for example, Public Finances in EMU (2005).
[103] See again Section 4.1.1.

expenditure. "Financial contributions to achieving European policy goals, notably the unification of Europe" may not just be taken to refer to the costs of German unification, but could perhaps be interpreted as any contribution to the EU budget. In fact, this formulation could probably be used to justify a deficit in excess of three per cent of GDP with any type of expenditure, since it is difficult to think of any reasonable policy objective that has not been endorsed at the European level.

It is irrelevant that the formulations discussed above allow *theoretically* for both more and less stringent interpretations. As discussed in Section 2.2, the problem in the first place is the deficit bias that tends to arise under discretionary decision-making and which the EU fiscal rules were designed to counteract. Any changes in the rules that open up for more of discretionary decisions will therefore weaken the constraining effect of the rules, because policy makers do not have incentives to use the possibilities of greater stringency.

According to the new Regulation on the excessive deficit procedure, "the other relevant factors" shall be taken into account only under the "overarching" condition that "the deficit remains close to the reference value (the three-per-cent deficit ceiling; the author's comment) and its excess over the reference value is temporary". This stipulation puts a limit to how large the deviations from the three-per-cent ceiling can be. But it is not clear exactly what this limit is. Presumably a deficit of 6 per cent of GDP is not close to 3 per cent. Nor is probably 5 per cent, but what about 4 or 4.5 per cent?

Severe cyclical downturn

The new definition of a "severe cyclical downturn" also widens the scope for fiscal deficits. However, this reformulation is much less problematic than the stipulations regarding "other relevant factors".[104] The cyclical downturn stipulation is more precise and leaves less room for discretionary judgements. The requirement of negative growth is well defined. The stipulation that a deficit above three per cent of GDP can be allowed if there has gradually evolved a large negative output gap ("a protracted period of *very low* (italics added) growth relative to potential") is more open to interpretation as there is no unique way of estimating potential output growth and output gaps.[105] Still, this revision makes economic sense, especially for the new member states. Since they will be growing much faster

[104] See Buti and Franco (2005) for a similar conclusion.
[105] Note that the application of the cyclical-downturn exemption, too, is conditional on the deficit remaining close to the three-per-cent ceiling.

than the old EU countries during a long period of income convergence, they might suffer serious economic downturns – with substantial reductions in employment – from reductions only in the growth, but not in the level, of output. It may be a reasonable trade-off to accept somewhat greater difficulties of verifying violations of the rules in order to allow fiscal policy to play a larger stabilising role in downturns. However, for reasons of verification, it would have been better with an exceptionality clause, defining a severe cyclical downturn as a deviation of a certain magnitude from a moving average of earlier growth rates.

Other changes

The new requirement that an annual minimum budgetary effort is needed if a country has not reached its medium-term objective, the "commitment" to enhanced budgetary discipline in recoveries and the agreement to put increased emphasis on the debt criterion have been interpreted by the Commission as counterbalancing the increased scope for deficits due to "other relevant factors" and the widening of the cyclical-downturn exemption.[106] These "counterbalancing" changes have very little "bite", though, as they are not backed by any sanction possibilities.

4.2 The changes in the enforcement procedure

Just as with the changes in the economic contents of the stability pact, some changes in the enforcement procedure tend to reduce the strictness of the pact, whereas others tend to increase it. However, once again the changes weakening the pact apply to its hard parts, whereas those strengthening it mainly concern the soft parts. Overall, the changes reduce the strictness of enforcement radically.

Extended deadlines

A number of changes in the pact extend the maximum time before sanctions should be imposed. These changes are summarised in Table 9, which shows various theoretically possible scenarios for the excessive deficit procedure in the future.

A major weakening of the enforcement mechanism concerns the *initial deadline* for correcting an excessive deficit. According to the original pact, the deadline for correcting an excessive deficit was the year after its identification – normally the second year after its occurrence – unless "special

[106] Public Finances in EMU (2005).

Table 9 Theoretically possible scenarios for the excessive deficit procedure in case of non-compliance (time until first fine)

Year	Old pact as originally envisaged and strict application of new pact	Lax application of new pact	Very lax application of new pact	Super-lax application of new pact	Maximum laxity according to new pact
t	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP
t+1	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Excessive deficit exception
t+2	Deadline for correction				Council decision on excessive deficit and recommendation
t+3	First deposit	Extended initial deadline	Extended initial deadline	Extended initial deadline	
t+4	Second deposit	First deposit	Repeated recommendation and new extension of deadline	Repeated recommendation and new extension of deadline	Extended initial deadline
t+5	First deposit converted into fine	Second deposit	First deposit	Repeated notice and further extension of deadline	Repeated recommendation and new extension of deadline
t+6		First deposit is converted into fine	Second deposit	First deposit	Repeated notice and further extension of deadline
t+7			First deposit converted into fine	Second deposit	First deposit
t+8				First deposit converted into fine	Second deposit
t+9					First deposit converted into fine

Note: The table has been constructed under the assumption that a deficit above three per cent of GDP is identified the year after its occurrence. Later identification would lengthen the period before fines should be imposed according to the new rules.

circumstances" (which were not specified) could be invoked. The implication was that a country could normally run an excessive deficit for up to three years before being exposed to a sanction in the form of a deposit. Although the same provision remains the basic rule, the revised stability pact puts more emphasis on the possibility to set the initial deadline one year later "in case of special circumstances". It is agreed in the Ecofin Council report that the existence of such "special circumstances" will be judged after a "balanced overall assessment" of the same "other relevant factors" that can justify why a deficit above three per cent of GDP should not be considered excessive in the first place.[107]

The new Regulation on the excessive deficit procedure requires a country with an excessive deficit to achieve "a minimum annual improvement of at least 0.5 % of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures". The Commission has argued that this stipulation counterbalances the reduction in the strictness of enforcement associated with the possibility to set an extended initial deadline, as it makes clear that one-off or other temporary improvements in the budget balance are not enough.[108] But this interpretation is questionable, since the report of the Ecofin Council also stipulates that a reason for setting an extended initial deadline is that the "minimum fiscal effort" is not sufficient for correcting the excessive deficit in normal time (the year after it has been identified). The implication is that a country with a large excessive deficit has longer time to correct it than a country with a small such deficit.

In addition, the reform of the stability pact allows for *later-stage extensions* of the deadlines for correcting an excessive deficit and for *repetitions* of both a recommendation and a notice from the Ecofin Council. Such a revised recommendation or notice should again take into account the same "other relevant factors" that should be considered in the initial decision on whether or not a deficit above three per cent of GDP is excessive.[109] A necessary condition for such later-stage extensions is "unexpected adverse economic events with major unfavourable consequences for government finances" during the excessive deficit procedure. The extensions are also subject to the constraint that effective action has been taken by the member state in compliance with the initial recommendation or notice. The possible extension is one year, both in the case of a repeated recommendation and in the case of a repeated notice. In sum, according to

[107] See Section 4.1.
[108] Public Finances in EMU (2005).
[109] See Section 4.1.

this provision, it thus seems possible to extend the deadline by two years as compared with the normal case.

The possible extensions of the deadline for correcting an excessive deficit are complemented with changes that lengthen the delays between the various steps in the excessive deficit procedure. Together, these changes lengthen the overall maximum period after which the Council is expected to impose sanctions if a eurozone state fails to comply with the successive decisions of the Council from 10 to 16 months in the normal case (without extensions of the deadlines).

The changes in the deadlines clearly decrease the strictness of enforcement: as is clear from Table 9, the maximum length of time before a country with an excessive deficit is required to pay a deposit is extended from three to at least four (column 2 in the table), and possibly up to six (column 4) years (under the assumption that a deficit above three per cent of GDP is identified in the year after its occurrence and is then classified as an excessive deficit).[110] This extends the maximum length of time before a fine should be paid from five to six (column 2), or possibly eight (column 4) years (under the same assumption as above). If use is made of the possibility to refrain from classifying a deficit above three per cent of GDP as excessive when it first arises, the maximum time periods before imposition of deposits and fines could even lengthen to seven and nine years, respectively (column 5). Such an enforcement procedure cannot possibly be regarded as strict.

Early warnings and Commission reports

One change at the "soft" end of the enforcement procedure concerns the *early warnings*.[111] According to the original stability pact, the Council could issue an early warning to a member state that deviates significantly from its medium-term fiscal objective (or the adjustment path towards it) and therefore risks running an excessive deficit. However, as discussed in Section 3.2.1, recommendations from the Commission that early warnings should be given were in three out of four cases blocked in the political decision-making process in the Council. To avoid this in the future, the Commission alone will be able to give so-called *policy advice* to member states as a substitute for early warnings by the Council, according to the agreement among finance ministers in Ecofin Report 7423/05. This provision

[110] The maximum time is, of course, even longer if it takes longer than a year to identify a deficit above three per cent of GDP. The Greek and Italian cases illustrate clearly that this scenario is a very realistic one. This is discussed further in Sections 3.2.1 and 5.1.

[111] See also Section 3.1.

was at the time of the agreement (March 2005) seen as a temporary measure, pertaining to the period before the adoption of the proposed Constitution, which stipulates that the right to issue formal early warnings should be transferred from the Council to the Commission. But with the present uncertainty as to whether the Constitution, or parts of it, will ever be adopted, the provisional stipulation in the agreement may now apply more permanently.

Another "soft" change in the direction of increased strictness concerns the reports of the Commission that may initiate an excessive deficit procedure. According to the original stability pact, there was no obligation on the part of the Commission to write a report if a deficit above three per cent of GDP were considered to be the result of "an unusual event outside the control of the member state" or "a severe downturn". According to the revised pact, in the future the Commission shall always write a report when the deficit of a member state exceeds, or threatens to exceed, the three-per-cent ceiling.

Conclusions on the enforcement procedure

Compared to the possibilities of extending the deadlines, the new right of the Commission to give policy advice as well as its obligation always to prepare a report when the three-per-cent ceiling is exceeded are marginal measures. Both measures also concern early and soft phases of the procedures (the preventive arm and the starting-up of the excessive deficit procedure).[112]

The crucial change in the enforcement procedure – as well as in the economic contents of the rules – is the widening of the discretionary decision-making power of the Ecofin Council. This obviously exacerbates, rather than mitigates, the main problem of the stability pact, which is the lack of enforcement. As discussed in Section 3.3, there exist in principle two ways of addressing the enforcement problem. The first one is to move enforcement away from the political sphere and instead delegate it to the judicial sphere, that is the European Court of Justice. The second way is to modify the sanctions in such a way that the application of them becomes credible

[112] An adoption of the provision in the proposed Constitution that a Council decision on whether a deficit in a member state is excessive shall be based on a proposal from the Commission, rather than on a recommendation, would have been a somewhat more important change: the Council would be obliged to accept such a proposal unless it is rejected unanimously. (With a recommendation from the Commission, as is now the case, a qualified majority in favour is needed for adoption.) However, this change has now been put on hold after the breaking-off of the ratification process for the Constitution.

also under political decision-making. The reform of the stability pact takes no steps in any of these directions.

Some of the formulations in the agreement of the finance ministers on the revised stability pact in the Ecofin report 7423/05 are very indicative of the weakening of enforcement mechanisms. Whereas "peer pressure" to achieve fiscal discipline was earlier an important catchword, the report instead talks of "peer support and peer pressure". Another revealing formulation is that "the purpose of the excessive deficit procedure is to *assist* rather than to punish" (italics added). This is obviously very far from the intentions behind the original German proposals on the stability pact in 1995/96.[113]

4.3 Overall assessment of the changes in the stability pact

The changes in both the economic contents and the enforcement mechanism of the stability pact represent a significant move away from a rules-based system back to a system of discretionary fiscal policy making. This applies to whether or not a deficit shall be considered excessive, to the speed with which an excessive deficit shall be corrected and to the timing of sanctions. Since the rationale for the original imposition of EU rules was to constrain the deficit bias that may exist in a discretionary policy setting, the widening of the scope for discretionary decisions is bound to weaken the budgetary discipline fundamentally. There is no reason to expect discretionary political decision-making in the fiscal policy area to work better in the future than it did in the past.

Some formulations in the Ecofin Council report appear almost as jokes. The report states that the reforms will "strengthen credibility and enforcement" of the stability pact and emphasises "the need for keeping the rules-based system simple, transparent and enforceable". According to other formulations, the "excessive deficit procedure should remain simple, transparent and equitable" and "the guiding principle for the application of the procedure should be "the prompt correction of an excessive deficit". These formulations say exactly the opposite of what the reforms imply. In fact, the EU fiscal framework is changed into a *complex, non-transparent and unenforceable* one. The risk that countries will be treated differently increases substantially. The future guiding principle for the excessive deficit procedure seems to be a slow, rather than a prompt, correction of excessive deficits (if deficits above the three-per-cent ceiling are at all classified as

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[113] See Section 3.3.3 as well as Costello (2001) and Stark (2001).

excessive). Euphemisms are a core element of politics, but EU agreements in general and the reform of the stability pact in particular must get top marks on this point. The EU jargon used in the report of the Ecofin Council shows – without any other parallels – close similarities to the Newspeak in George Orwell's *Nineteen Eighty-Four*.[114]

It has been argued that more "flexible" rules, allowing more consideration of other policy goals than fiscal discipline, may increase the *legitimacy* of the rules and thus secure more political support for strict enforcement.[115] This argument would have carried some weight if the revisions of the economic contents of the rules had instead taken the form of only a few well-defined amendments, introducing transparent contingency clauses (exact stipulations on how debt levels, growth rates or various types of expenditures would affect the deficit ceiling). But the argument is wrong when other policy objectives are to be taken into account in a discretionary and loosely defined way. Strict *ex post* sanctions against excessive deficits that have not been clearly defined *ex ante* can never command legitimacy.

Sanctions imposed through more discretionary decision-making would probably also increase the risk of political conflicts among EU member states. If sanctions were automatic (or decided by the Court of Justice as proposed by EEAG 2003 and Calmfors and Corsetti 2003), the risk of such conflicts would be much smaller. But the more discretionary the decisions on sanctions are, the larger the risk that the state being exposed to them will regard them as "hostile actions" by other member states. This serves also to decrease the probability that sanctions will be imposed in the future.

There are elements in the stability pact reform that make the rules more adequate. These include the greater tolerance of deficits in severe downturns, the differentiation of medium-term fiscal objectives in order to take heterogeneity among countries in both debt levels and potential growth rates into account, the attempts at increasing the emphasis on debt developments in general, the plans on better assessment of implicit debt and long-run sustainability, and the "commitments" to avoid procyclical fiscal policy. But the main thrust of the reform is to increase the possibility of running large budget deficits over long periods of time. On the whole, the reform of the pact represents a missed opportunity to change the fiscal rules in a socially efficient way. As discussed in Section 3.3.2, there were good arguments for amending the earlier rules by taking more contingen-

[114] Orwell (1949).
[115] See, for example, Buti, Eijffinger and Franco (2005), who quote this argument.

cies into account. The optimal strategy would have been to counterbalance limited and well-defined changes to make the rules more "flexible" by increases in the strictness of enforcement, so that violations of the revised rules would meet with heavier (or at least more credible) sanctions than violations of the earlier rules.[116]

By both reducing the weight of fiscal discipline relative to other policy objectives and weakening the strictness of enforcement, the reforms of the rules have missed the opportunity of trading off more "flexibility" against stricter enforcement. This failure is logical, as the main purpose of stability pact reform was not to improve the EU fiscal framework, but instead simply to reduce the short-run risks that the governments in the large EU states would be branded for fiscal profligacy.

The most worrying aspect of the reform of the stability pact is not the actual changes that have been implemented. It is the demonstration that the rules are endogenous and likely to change in response to violations of them, at least if the perpetrators are large countries. What has happened is that the opportunistic, discretionary decision-making characteristic of unconstrained year-to-year fiscal policy making has come to encompass the "constitutional" level of EU rules as well. This is likely to have grave consequences for the future. Why should the new rules be more credible than the earlier ones, once it has been shown that the rules can be changed in response to emerging events? This loss of credibility implies in effect that the attempts to use the EU as an external enforcer and a vehicle for establishing the constraints on fiscal policy that were difficult to do at the national level have largely failed.[117]

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[116] This point has been elaborated by Beetsma and Debrun (2005).
[117] See the discussion in Section 2.2.

5 WHERE TO GO NEXT?

My analysis leads to pessimistic conclusions. The watering-down of the stability pact has undermined the incentives for fiscal discipline. A large step has been taken from a rules-based system in the direction of discretionary decision-making. This opens up the door for a further weakening of fiscal discipline.

All this occurs at an unfortunate time. First, potential growth in the euro area has slowed. This implies that a given deficit ratio will in the long run lead to a higher debt ratio than in the past.[118] Second, demographic developments will be putting increasing pressure on public finances. One should not, however, expect any sudden collapse of budgetary discipline. A process where contagion effects gradually spread among countries is more probable: deficits in one country are likely to be used as an excuse for deficits in others. This process is also evident in a (so far) fiscally disciplined country as Sweden, where the government has excused departures from the fiscal goals with the argument that the situation is much worse in other European countries.[119] Such reasoning is a natural consequence of the fact that the performance of other EU countries has become the main norm of comparison for national macroeconomic policy within the EU.

A gradual weakening of fiscal discipline may not appear dramatic. So far, the violations of the EU deficit ceiling and the loosening of the stability pact have not triggered any major reactions in financial markets. But this is no reason for complacency. A major justification for fiscal constraints in the first place is that financial market reactions are often erratic: they are usually slow to come, but when they come, they tend to be both sudden and dramatic.

One aspect of the fiscal policy problem concerns the interaction with monetary policy. The euro area has in recent years been characterised by an unfortunate macroeconomic policy mix with loose fiscal policy and relatively strict monetary policy (in particular compared to the US during the latest downturn). Part of the reason may be that the ECB has chosen an overambitious price stability target (with a two per cent *ceiling* for inflation rather than a symmetric inflation target with a tolerance margin as in, for example, Sweden or the UK).[120] The large budget deficits in some eurozone countries have probably increased further as a response to the monetary

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[118] This point has been emphasised by CEPS (2005) in particular. See also Section 3.2.1 above.
[119] See Calmfors (2005b).
[120] See, for example, EEAG (2003).

policy of the ECB. This risks creating an unstable situation. Pressures on the ECB to adjust its policies are likely to increase in the future. The ECB will try to resist such attempts. But if government debt builds up, political pressures to allow higher inflation, which would erode the real value of debt, may gradually increase. This might ultimately trigger political decisions on fundamental institutional changes that circumscribe the independence of the ECB and thus pave the way for higher inflation. Such a development could have profound implications for the cohesion of the euro area. The balance between advantages and disadvantages of euro membership could change fundamentally.

In contrast to what most people might believe, the greatest threat to the cohesion of the euro area may not come from discontent in low-growth/high-debt countries, but rather from inflation fears in the more well behaved countries. This risk should not be exaggerated. But the interaction between debt dynamics in some of the large EU economies and overall inflation in the euro area might in the future lead to a re-assessment of the pros and cons of the common currency in some of the smaller eurozone countries that now have more stable public finances.

A serious weakening of fiscal discipline in the EU economies, as outlined above, is the most realistic scenario, but not unavoidable. Future developments will depend on both how the revised fiscal framework at the EU level is used and whether the weakening of the stability pact can be compensated for through other means.

What are the options if one wants to minimise the adverse effects of the revision of the stability pact? I shall discuss three possibilities:

1. A strict application of the revised EU fiscal framework in order to set a precedent for the future.
2. A "sustainability pact" among only some EU countries in order to strengthen fiscal discipline, for example by improving the link between fiscal policy making at the EU and at the national level.
3. A strengthening of national institutions designed to promote fiscal discipline

The three methods can work as complements reinforcing each other. But they can also serve as substitutes. More precisely, if it proves impossible to apply the revised EU fiscal framework strictly and to improve the links between the EU and the national levels of decision-making, the only remaining option is to focus on stronger national institutions to promote fiscal discipline.

5.1 A strict application of the revised stability pact

As analysed at length in Section 4, the increased importance of discretionary decision-making in the revised stability pact opens up for a more lenient attitude towards government debt accumulation. Still, the ultimate outcome depends on exactly what discretionary decisions the Ecofin Council will take. The Council can choose to be lenient or to apply the revised rules strictly in order to invest in future credibility. By acting strictly, the Council could establish a precedent for the future, which would limit the loosening of the pact to what has already occurred *de facto* under the old rules.

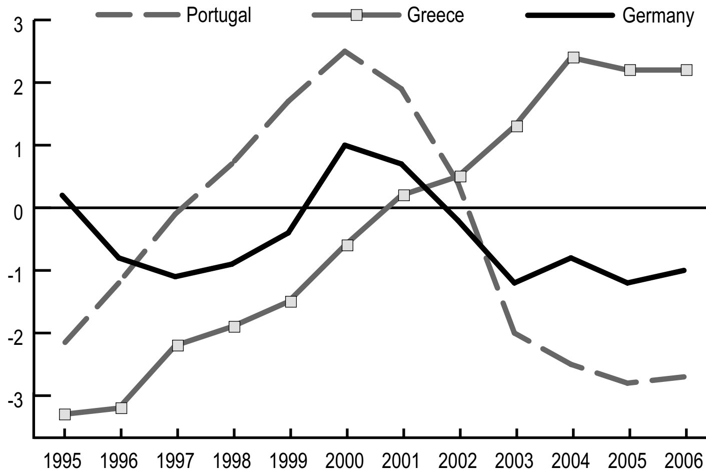
5.1.1 Greece[121]

Greece represents the most flagrant violation of the rules so far.[122] The annual deficit ratios has for eight years (1997–2004) been above the three-per-cent ceiling (by on average 1.7 percentage points; see the earlier Table 3). The fiscal statistics have systematically been misreported, which allowed Greece to enter the euro area in 2001 despite not in reality fulfilling the convergence criteria. The breaches of the three-per-cent deficit limit first became known in September 2004; the deficit and debt figures were then further revised upwards in March 2005 and there may yet be more upward revisions to come. Fiscal policy has been procyclical (with recent deficits occurring, not in a downturn, but in a boom, as seen in Figure 4a). Debt ratios are very high (around 110 per cent of GDP) and likely to increase in 2005/06 (see the earlier Table 5a). In the on-going excessive deficit procedure, in February 2005 Greece was – under the rules of the old stability pact – given an extended deadline until 2006 (that is *two* years after the large deficits were discovered) to correct its excessive deficit. This was motivated by the existence of "special circumstances", more precisely the size of budgetary adjustments needed to reduce the deficit below three per cent of GDP. Given the extent of violations in the case of Greece, the treatment of this country has been extremely lenient even according to the revised and more permissive rules.

If Greece does not correct its excessive deficit in 2006, there can be no escape from imposing sanctions if any credibility for them is to remain. Not to have done so already has been a grave mistake, which has further undermined the credibility of the EU fiscal framework. The delays in reining in the fiscal deficits in Greece may also turn out to be very detrimental to macroeconomic performance in the country, because the expansionary

[121] See also the earlier Table 6a.
[122] See also Section 3.2.1. for an account of the Greek situation.

Figure 4a Output gap (per cent of GDP) for Germany, Greece and Portugal, 1995-2006



Note: 2005 and 2006 values are estimates using data up to 16 March 2005.

Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

fiscal policy has contributed to a large real exchange rate appreciation (see Figure 5a). This is bound to exacerbate the next downturn and then make a correction of the excessive deficit very painful.

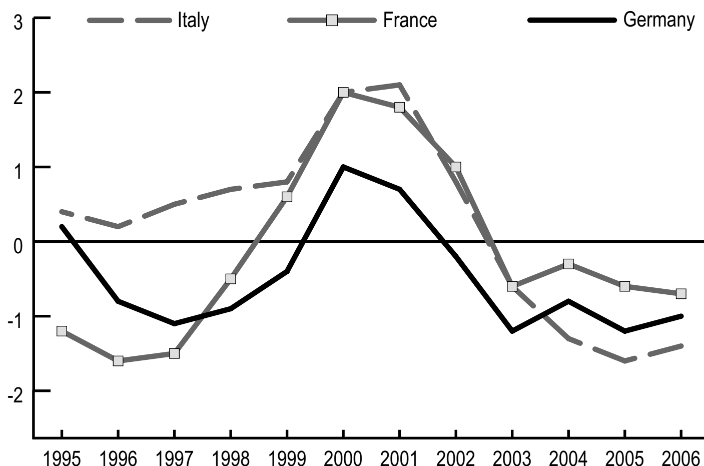
5.1.2 Italy, Portugal and the UK[123]

Three new excessive deficit procedures, against Italy, Portugal and the UK, have at the time of writing (October) been opened this year (2005) after the reform of the stability pact. As discussed in Section 3.2.1, the Italian deficits figures for 2003 and 2004 were in May this year revised upwards from slightly below to slightly above three per cent of GDP (see also the earlier Table 3a). The latest Commission forecasts (under the assumption of no change in policy) are budget deficits in 2005 and 2006 of 3.6 and 4.6 per cent of GDP, respectively.[124] Although the earlier Italian deficits were considered to be "close" to the three-per-cent deficit ceiling, they were still classified as excessive by the Ecofin Council. The reasons were

[123] See also the earlier Table 6a.

[124] *Report from the Commission on Italy* (2005).

Figure 4b Output gap (per cent of GDP) for France, Germany and Italy, 1995-2006



Note: 2005 and 2006 values are estimates using data up to 16 March 2005.

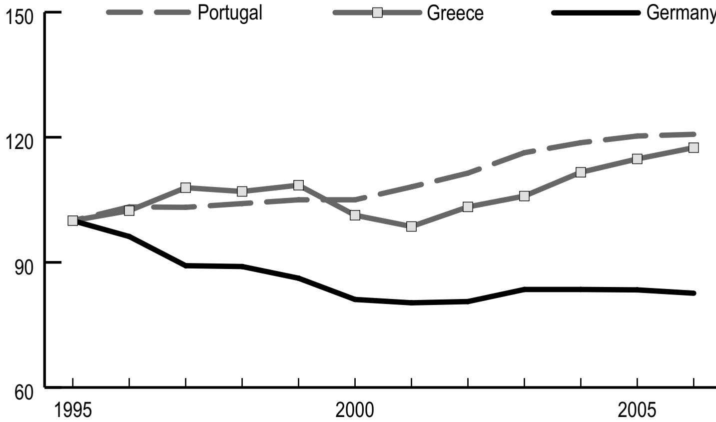
Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

that they were not "temporary" and that the debt ratio (which has been hovering around 106–107 per cent of GDP) "has not declined at a satisfactory pace over recent years".[125] Italy was, however, given an extended deadline by one year (until 2007) to correct its excessive deficit, because the risks that a large budgetary correction would "prove economically costly" in a situation of "cyclical weakness" were regarded as sufficiently "special circumstances".[126]

As concerns Portugal, a forecast deficit of 6.2 per cent of GDP this year (2005) was identified by the Commission in June.[127] With unchanged government policy, the deficit ratio is projected to stay above the three-percent ceiling in both 2006 (4.8 per cent) and 2007 (3.9 per cent). The debt ratio, which is above 60 per cent of GDP, is forecast to increase over 2004–07 (from 61.9 per cent of GDP in 2004 to above 68 per cent in

[125] *Council Decision on the Existence of an Excessive Deficit in Italy* (2005).
[126] *Council Recommendation to Italy* (2005).
[127] *Report from the Commission on Portugal* (2005)

Figure 5a Real exchange rates (relative unit labour costs) for Germany, Greece and Portugal, 1995-2006



Notes: 1995=100. Relative unit labour costs refer to the whole economy. 2005 and 2006 values are estimates using data up to 16 March 2005.

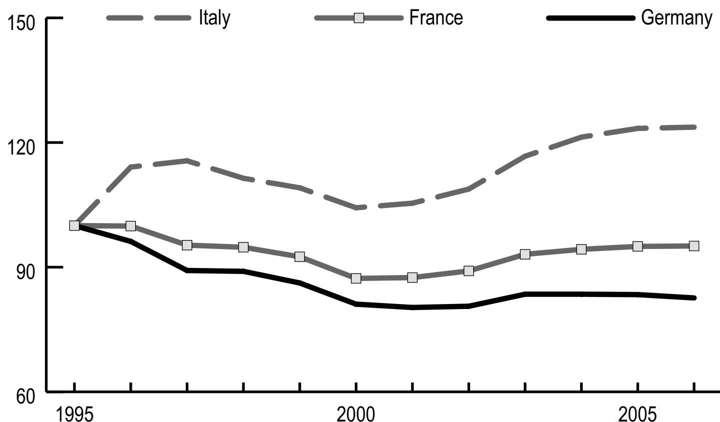
Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

2007). On the basis of this, the Council has classified the deficit as excessive, as it is considered to be neither temporary (three years with a forecast deficit above three per cent of GDP) nor close to the ceiling.[128] Although "the negative output gap is considered to be "sizable", the deterioration of the government budget balance is seen as "out of proportion". Like Italy, Portugal has been given an extended deadline (in the Portuguese case until 2008) for correcting the excessive deficit (three years instead of two after its occurrence).[129] The motivation for the extension is the same as for Italy.

For the UK, a deficit above three per cent of GDP was identified for the second consecutive fiscal year in 2004/05.[130] This has triggered a report from the Commission, which concluded that, although the excess over the three-per-cent limit is small, it is not temporary: hence the stipulations on

[128] *Council Decision on the Existence of an Excessive Deficit in Portugal* (2005).
[129] *Council Recommendation to Portugal* (2005).
[130] Note that the evaluation of the excessive deficit criterion for the UK is based on fiscal instead of calendar years. According to the Commission forecast, the deficit will remain above the three-per-cent ceiling also in 2005/06.

Figure 5b Real exchange rates (relative unit labour costs) for France, Germany and Italy, 1995-2006



Notes: 1995=100. Relative unit labour costs refer to the whole economy. 2005 and 2006 values are estimates using data up to 16 March 2005.

Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

"other relevant factors" cannot be invoked when judging whether the deficit is excessive.

The treatment of Italy, Portugal and the UK gives some indications on future excessive deficit procedures under the new rules. In all three cases, the decisions so far have followed the stipulated "overarching principle" that "other relevant factors" cannot justify exemptions unless deficits above the three-per-cent ceiling are "temporary" and "close" to it. It is still not clear how "temporary" and "close" are interpreted. The case of Portugal indicates that a deficit of 6.2 per cent of GDP is not considered "close" to three per cent, whereas the evaluation of Italy shows that a 3.2 per cent deficit is. So the limit could be anywhere in the 3.2–6.2 interval. As concerns the definition of a "temporary deficit", the decisions on Italy and Portugal make it clear that deficits during three years are not seen as temporary.

The most worrying thing about the Italian and Portuguese cases is that they suggest a lax interpretation of the rules regarding deadlines. According to the revised stability pact, the same "other relevant factors" as in decisions on the existence of an excessive deficit should be taken into

account when setting the initial deadline. For Italy and Portugal, considerations regarding the cyclical situation of the economy and the pains associated with large budgetary adjustments have been given much larger weight than considerations with respect to debt developments and long-run sustainability.

To retain as much credibility for the fiscal framework as possible, it is vital that additional steps in the excessive deficit procedure, including the use of sanctions, are taken against Italy and Portugal if they do not follow the adjustment path prescribed by the Ecofin Council. But both the Italian and Portuguese cases could very well develop into serious stress tests of the revised fiscal rules. The budget deficits may very well increase substantially, if there is not enough political resolve to address the situation. A complicating factor for both countries is the large real exchange rate appreciations that have taken place. They are likely to cause prolonged downturns (see Figures 4a and b as well as 5a and b).

5.1.3 France and Germany

But the most crucial decision for the credibility of the revised stability pact will be how the ongoing excessive deficit procedures for France and Germany are phased into the revised stability pact. These countries have already, as discussed in Section 3.2.1, been given an extra year (2005) to correct their excessive deficits. But, if the excessive deficits are judged to persist both this year and the next (which seems likely; see the earlier Table 3a), the procedures for the two countries must be set back on track. This implies that the Ecofin Council should as soon as possible give notice to France and Germany to take further corrective actions and, if that does not help, move swiftly to sanctions. If this is not done, yet another precedent of lax interpretation of the rules will be set, which will from the start also undermine the credibility of the new looser rules.[131]

[131] The initial excessive deficits in France and Germany appeared in 2002. Normally, the excessive deficits should thus have been corrected in 2004. One could perhaps regard the extra year (2005) given for correction of the excessive deficits, according to the Commission's interpretation of the Council's conclusions in November 2003 and the subsequent Court of Justice ruling in July 2004 (European Commission 2004a), as the equivalent of an extension of the initial deadline and a repetition of the first Council recommendation in the reformed stability pact. Such a revision of the original deadline could be justified by the unexpected slow-down of growth in both countries in 2003. A further extension in connection with a notice to Germany and France to take additional corrective action would have to be motivated by yet more negative growth surprises with major fiscal effects in 2005. Such an argument would not be convincing. On the contrary, it would strengthen the belief that sanctions cannot be imposed on these countries.

5.1.4 The chances of a strict application

How large are the chances of a strict application of the revised stability pact? Unfortunately, not very large. The changes in the pact were undertaken to avoid a strict application, so it is difficult to see why politicians should take a more long-term view when coming to discretionary case-by-case decisions than when revising the rules at "the constitutional level". Indeed, as analysed in Section 4, one should expect politicians to use the increased freedom of action, given by more discretionary decision-making power, precisely to loosen fiscal discipline. The only reason to hope for a strict application would be if politicians were to realise that, after the revision of the rules, there is a larger need for investing in a "good reputation" than before. But it is difficult to see why they would have such an insight *ex post* when they did not have it *ex ante*.

The weakness of the enforcement procedure, which is the main deficiency of the fiscal rules, has been reinforced by the revision of the stability pact. The best way to guarantee strict enforcement would be *transparent rules with contingencies* in combination with a *depoliticisation* of decisions in the enforcement procedure, preferably through delegation to the European Court of Justice, as discussed in Section 3.3. If the new fiscal framework, based on more of discretionary political decision-making, should stand any chance of functioning, further reforms of it are required to strengthen the enforcement mechanism:[132]

- To reduce the risks of collusive behaviour, countries with excessive deficits should not be allowed to vote in the excessive deficit procedures against other countries.
- To strengthen the incentives to actually make use of sanctions, deposits and fines should not be front-loaded (that is larger in the first than in subsequent years). This implies that the fixed part of the deposits and fines in the first year they are imposed (0.2 per cent of GDP) should be scrapped and only the variable part (0.1 per cent of GDP for each whole percentage point excess of the budget deficit over three per cent of GDP) retained. There is also a case for further lowering the size of deposits and fines in order to make them less of an "atomic bomb".
- In addition, one should consider complementing smaller pecuniary sanctions with non-pecuniary ones. The latter could involve a gradual loss of voting power – in all issues – in the Ecofin Council for member states with excessive deficits. Such non-pecuniary sanctions would not suffer

[132] See also Section 3.3.

from the legitimacy problem of pecuniary sanctions arising because they exacerbate the deficit problem they are designed to mitigate.

Unfortunately, such reforms are not on the political agenda. Politicians are not likely to be willing to enter into new discussions on further changes in the stability pact (which specifies the size of deposits and fines), since this could provoke new political conflicts among member states. Reforms of voting rules, which would require changes in the Treaty (Constitution), are even more unlikely with the present stalemate in the ratification process for the proposed Constitution.

5.1.5 Statistical reporting

The only measure to strengthen the EU fiscal framework on which there seems to be general agreement concerns budgetary statistics. The need for accurate such statistics has been highlighted by the large *ex post* revisions of the deficit and debt figures for Greece back to 1997, but also by the smaller revisions of the 2003 and 2004 deficit figures for Italy.[133] Measures are now being taken both to improve the monitoring capacity of the Eurostat and to set European standards for the independence and professional competence of national statistical offices.[134] It is obviously a minimum requirement for the future credibility of the EU fiscal framework that the accuracy of the budgetary statistics is improved, so that breaches of the rules do not go unnoticed for long periods. The report of the Ecofin Council on the revision of the stability pact raises the possibility of imposing sanctions on a member state "when there is infringement of the obligations to duly report government data".[135] To actually introduce such a sanction system is imperative. But although more accurate budgetary statistics would be helpful, it can never make up for a lack of determination to apply the fiscal rules strictly.

5.2 Enhanced fiscal policy co-operation among fiscally responsible EU states

A second way of counteracting the loosening of the stability pact might be to strengthen the fiscal policy links between the EU and the national levels, so that EU-level considerations can exert a greater influence nation-

[133] See the earlier discussion in this section as well as Section 3.2.1. The underreporting of deficits in Greece was discovered after the change in government in 2004. Similarly, earlier underreporting of deficits was discovered in Portugal in 2003 after a change in government.
[134] See Public Finances in EMU (2004, 2005).
[135] Ecofin Report 7423/05.

ally. One obvious deficiency of the EU fiscal framework has been the "disconnect" between fiscal policy deliberations at the EU level and those at the national level. The commitments at the EU level have often not been anchored in any broad domestic policy debate and actual domestic budget decisions have often been quite independent of these commitments. Such inconsistencies between domestic policies and EU commitments are not specific to fiscal policy, but a reflection of a general failure of integrating the national and EU-level policy debates. This has contributed greatly to the present crisis of confidence for the EU and the perception that the EU is a project mainly for the political élite. The consequences in the fiscal policy area threaten to be particularly serious.

5.2.1 Better links between EU-level and national decision-making

The report of the Ecofin Council on the revision of the stability pact contains some ideas to address the "disconnect" between EU-level and national-level fiscal policy decisions. Governments are "invited to present stability/convergence programmes and the Council opinions thereon to their national Parliaments". The report also concludes that "national Parliaments may wish to discuss the follow-up to recommendations in the context of the early warning and the excessive deficit procedures". New governments taking office are "invited" to outline their budgetary strategy "for the whole legislature" when presenting their first update of the stability/convergence programmes. Finally, member states are requested to explain "divergences between the national and the Commission forecasts" in their stability/convergence programmes.

The measures outlined in the report of the Ecofin Council would be helpful, but remain modest. The formulations that member states "are invited" to adopt measures or "may wish" to do so represent only weak commitments. An effective programme should go much further. Key to a better interaction between the EU and national levels would be that the Commission and the Ecofin Council present their evaluations of national fiscal policy (opinions and policy advice in the surveillance process as well as reports and recommendations in the excessive deficit procedure) in the national arena.[136] Such presentations could be made in the national parliaments. These could also commit to organising public hearings based on the Commission and Council evaluations, to which representatives from these bodies should be invited, and to holding parliamentary debates on the basis

[136] This point has been made in, for example, *An Agenda for a Growing Europe* (2004).

of them. The government could be obliged to respond formally to the evaluations as part of the national policy-making process. In addition, decisions on stability/convergence programmes could be taken by the parliament – and not only by the government as is now the case – in order to enhance the status of the programmes at the national level and achieve better consistency between them and actual budget decisions.

Reforms of this type could be made in an uncoordinated way by individual member states. But in the current confidence crisis for the EU, such national initiatives to boost EU influence are not very probable. To launch such reforms might require a European initiative. But a common EU initiative is not realistic either: it is difficult to see why governments that have just watered down the EU fiscal rules – out of a fear that they constrain the pursuit of own political goals too much – would be interested in giving EU institutions a larger role in the national policy-making process. The lack of commitment and precision in the report of the Ecofin Council supports this interpretation.

5.2.2 Enhanced co-operation: a fiscal sustainability pact

Are there other possibilities? Yes, there might be a third way. A select group of EU countries could launch a joint initiative: a *fiscal sustainability pact* to impose stronger incentives for fiscal discipline than has been possible to uphold in the whole of EU. Such an initiative could take several forms. It could be launched formally as a form of *enhanced co-operation*. The current EU Treaty permits such *flexible integration* if there are at least eight participants (2/3 of the member states according to the proposed Constitution), although the project must be approved unanimously by all member states. When thinking of enhanced co-operation, most people have a core consisting of the original EEC members, including Germany, France and Italy, in mind. Enhanced co-operation regarding fiscal policy should instead involve the fiscally more disciplined countries in the EU. The co-operation could include both members and non-members of the eurozone as well as both old and new EU states. Austria, Belgium, Denmark, Estonia, Finland, the Netherlands, Spain and Sweden could be suitable candidates. Other candidates might be Ireland among the old EU states and Latvia, Lithuania and Slovenia among the new ones.

The point of enhanced co-operation around fiscal policy among a number of "unconventional" countries would be twofold: to set an example of tighter fiscal discipline for other EU countries and to give a new impetus to EU co-operation in general. The co-operation could encompass both procedural rules for improving the links between the EU and national fiscal de-

Box 2: A blueprint for enhanced fiscal policy co-operation among the most fiscally responsible EU countries

Possible participants

- Prime candidates: Austria, Belgium, Denmark, Estonia, Finland, the Netherlands, Spain and Sweden.
- Other possible candidates: Ireland, Latvia, Lithuania and Slovenia.

Procedural commitments

- Decisions on stability/convergence programmes in the national parliament.
- Presentation of Commission and Ecofin Council evaluations (opinions and policy advice in the surveillance process as well as reports and recommendations in the excessive deficit procedure) in the national parliament.
- Commitment of the national parliament to hold public hearings and debates on the basis of these evaluations.
- Obligation of the government to respond to these evaluations as part of the national policy-making process.

Policy commitments

- Commitment to correct an excessive deficit already the year after it has been identified (and thus not to use the extended deadlines made possible by the revised stability pact) unless there are extreme circumstances.

Admittance criteria

- Deficit below the three-per-cent ceiling (or a more ambitious level) for a certain length of time.
- Debt ratio below the 60-per-cent debt ceiling (or, if the debt ratio is above the ceiling, that it has been diminishing at a fast pace for a certain period of time).

Advantages

- Example of tighter fiscal discipline for other EU countries.
- Example of "flexible integration", which could provide a new impetus for EU co-operation in general.

cision-making processes as outlined above. But one could also conceive of other components. One possibility would be a commitment on the part of the participating countries to correct excessive deficits already the year after they are discovered (and thus not to use the extended deadlines made possible by the reformed stability pact) unless there are extreme circumstances. One could also set up stringent requirements for being admitted to the enhanced co-operation, for example that budget deficits have been below the three-per-cent-of-GDP deficit ceiling (or an even more ambitious one) for a certain length of time and that debt is below the 60-per-cent-of-GDP debt ceiling (or, if it is above, that it has indeed been diminishing at a fast pace). The idea would be that the desire to be admitted to the group of fiscally responsible EU countries would enhance the in-

centives for fiscal restraint in qualitatively the same way as happened with the convergence criteria for entry into the monetary union.[137]

Political obstacles

Is there any realism in the proposal on enhanced fiscal policy co-operation among a subset of EU countries? One potential problem is that the fiscally less disciplined countries might veto it, as it would expose their own fiscal problems more clearly. Enhanced fiscal policy co-operation, involving only some countries, might also be perceived as a threat to the general cohesion of the EU. And the smaller countries might not want to provoke the larger countries by establishing such co-operation for the same reasons as they did not put up more of a fight against the revision of the stability pact and the earlier breaking-off of the excessive deficit procedures against France and Germany. If so, more informal co-operation, where a group of EU countries agrees to national-level reforms according to certain principles, might be less controversial.

Another caveat concerns domestic political support for more fiscal policy co-operation. The present mood among voters in most EU countries seems to be a fear that EU integration has proceeded too fast. This might involve scepticism also towards attempts at further increasing co-operation among EU countries along new lines and in other constellations than has earlier been envisaged. If the current crisis of confidence for the EU persists, there may be a fundamental lack of legitimacy for any attempts at imposing fiscal discipline through co-operation among (all or only some) EU states. Finally, one could question the effectiveness of measures of this sort, as they would not rely on any "hard" enforcement mechanism. These caveats notwithstanding, enhanced fiscal policy co-operation, as discussed here, could still be a new idea worth exploring.

5.3 Stronger national institutions to promote fiscal discipline

The third possibility of offsetting the risk of weaker fiscal policy discipline in the EU takes as its starting point the difficulties of making rules at the

[137] The proposal builds on the hypothesis that budget deficits in EU countries are so-called *strategic complements*, so that lower deficits in one country increase political pressures for fiscal restraint in others. A counteracting effect – tending instead to make deficits *strategic substitutes* – may operate in the eurozone: to the extent that lower budget deficits have positive spillover effects on other euro countries, as discussed in Section 2.2, the incentives for budgetary discipline in the latter countries would be weakened. One should, however, expect the latter effects to be limited if the enhanced co-operation involves mainly small countries.

European level function. One can view the enforcement problems for the earlier stability pact, its revision as well as the current confidence crisis for the EU as a whole as evidence that attempts to impose constraints on fiscal policy at the EU level do not work. The upshot is then that there is no way around establishing the necessary incentives for fiscal discipline at the national level. It may be only there that the required legitimacy for constraints on fiscal policy can be obtained.

Some passages in the report of the Ecofin Council on the revision of the stability pact reflect such insights.[138] The report stresses that "national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact" and that "national institutions could play a more prominent role in budgetary surveillance to strengthen national ownership, enhance enforcement through national public opinion and complement the economic and policy analysis at the EU level". These formulations are consistent with the Treaty stipulation that member states should "ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from the Treaty". But the report of the Ecofin Council does not go beyond general statements and does not give any guidelines for appropriate developments of national institutions.

5.3.1 The literature on national fiscal institutions

There exists a large research literature on the impact of national budgetary institutions on fiscal outcomes.[139] Some of this literature emphasises the importance of the internal decision-making structure of the government. One conclusion is that both a "delegation approach" and a "commitment approach" can be conducive to fiscal discipline.[140] "Delegation" means in this context that fiscal powers in the government are centralised to a "strong" finance minister or the prime minister. "Commitment" implies instead that a set of binding expenditure guidelines is negotiated collectively among ministers at the beginning of the budget process. It has been argued that "commitment states" have a decision-making structure that is better suited to compliance with the EU fiscal rules than is the case for "delegation states".[141]

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[138] Ecofin Report 7423/05.

[139] See, for example, Poterba and von Hagen (1999), Alesina and Perotti (1999) or Persson and Tabellini (2000).

[140] See von Hagen (1992), von Hagen and Harden (1994, 1996) and Hallerberg and von Hagen (1999).

[141] See von Hagen, Hughes-Hallet and Strauch (2002) and Hallerberg, Strauch and von Hagen (2003).

Other contributions have focused on the need for more "technocratic influence" over national policy making in EU states in order to offset the political bias towards fiscal profligacy. These contributions include among others Wyplosz (2002, 2005), the Swedish Government Commission on Stabilisation Policy in the EMU (2002), Sveriges Riksbank (2002), EEAG (2003, 2004), Calmfors (2003a,b), European Commission (2004b), Annett, Decressin and Deppler (2005), and IMF (2005).[142] In these analyses, national fiscal policy institutions have usually been viewed as a *complement* to the EU fiscal framework that could reduce the risks of violations of the rules. But in the situation that has arisen they are better regarded as *substitutes*.

5.3.2 Components in a national fiscal framework

What kind of reforms could one conceive of? A stronger national fiscal policy framework ought to consist of at least three parts.

1. *Well-defined national fiscal policy objectives* determined in advance by the parliament. These should include an objective for the budget balance over the cycle or the development of government debt over the cycle. An annual deficit ceiling might also be specified. The numerical targets and constraints could coincide with the EU targets, but might also be more ambitious. In addition, the national constraints could encompass expenditure ceilings, the motivation being that deficit problems usually originate on the expenditure side.[143] The objectives should also give *ex ante* guidelines for how fiscal policy should be used as a stabilisation tool. They could specify to what extent fiscal policy to stabilise the business cycle should rely on the automatic stabilisers and to what extent on discretionary action.[144] Such guidelines are likely to differ between those countries that have adopted the euro (or locked their exchange rates to it in ERM-2) and those countries that have not. Fiscal policy must necessarily play a larger role for eurozone countries, as it is the only demand management tool that can be used to stabilise country-specific macroeconomic shocks. For countries outside the eurozone, the main issue is instead in what situations fiscal policy should be used as a

[142] Earlier proposals on various forms of independent fiscal policy councils, not related to the EU in particular, have been made by, for example, von Hagen and Harden (1994), Eichengreen, von Hagen and Harden (1995), Wren-Lewis (1996, 2000, 2002), Blinder (1997), Ball (1997), Business Council of Australia (1999), Eichengreen, von Hagen and Hausmann (1999), and Seidman (2001).

[143] See Section 2.2.

[144] See in particular the Swedish Government Commission on Stabilisation Policy in the EMU (2002), Calmfors (2003a,b) and HM Treasury (2003, 2004).

complement to monetary policy.[145] Finally, to shorten decision lags and reduce the risk that stabilisation policy decisions are affected by other concerns (notably, income distribution considerations), it might be wise also to decide *ex ante* on which fiscal policy instruments to use for stabilisation purposes. As in the EU fiscal framework, there should be an exceptionality clause permitting deviations from the pre-set constraints under extreme circumstances outside the control of policy makers.

2. *Commitments to transparency*. A second ingredient in an improved national fiscal policy framework should be an *ex-ante* commitment to transparent policies so as to give a basis for as informed a debate as possible. Transparency requires that *creative accounting* and *one-off transactions* are not used to mask deficits and debt increases. It is one of the unfortunate by-products of the EU fiscal rules that such measures have come to be used to an increasing extent.[146] Another helpful measure would be an obligation for the government to indicate clearly in advance which fiscal policy measures are undertaken for stabilisation reasons and which are undertaken for other reasons. The purpose would be to avoid that various policy objectives are confounded and that measures designed to be temporary become permanent. To reduce this risk, one could also require that decisions on fiscal measures to stabilise the business cycle should specify how and when the measures are to be reversed.
3. *Incentives to avoid deviations from policy objectives*. Well-defined policy objectives and transparency are necessary, but not sufficient, preconditions for fiscal discipline. The crucial factor – at the national as well as the EU level – is appropriate incentives to avoid deviations from the policy objectives. The method adopted at the EU level has been simple numerical rules in combination with sanctions. This has not worked because the enforcement mechanisms are not credible. An alternative setup would be to constrain political behaviour through building in *discretionary countervailing powers* in the national decision-making process.

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[145] An obvious case is when monetary policy is rendered ineffective, because the economy is caught in a liquidity trap where nominal interest rates cannot be reduced below zero. Another reason for using fiscal policy as a means to increase aggregate demand is if stimulative monetary policy action is constrained by fears that it will trigger destabilising asset price increases. Alternatively, in such a situation, expansionary monetary policy can be combined with selective tax policies (for example, increases in stamp duties) to dampen asset price increases (see HM Treasury 2003, 2004). Changes in tax rates might sometimes also be an appropriate means of counteracting supply shocks.

[146] See, for example, von Hagen and Wolff (2004) and Public Finances in EMU (2005).

5.3.3 A national Fiscal Policy Council

An appropriate method of establishing such countervailing powers would be to set up a national *Fiscal Policy Council*, consisting of independent experts, to serve as a guardian of the principles of fiscal discipline at the national level decided by the parliament (and possibly also of commitments at the EU level). This could be done in ways that are more or less far-reaching. At one end of the scale, the objective would only be to increase the reputation costs for political decision makers of fiscal profligacy; at the other end it would be to give the independent experts some direct influence over fiscal policy decision-making.

1. A minimum assignment for a Fiscal Policy Council would be to produce independent forecasts, to make fiscal policy recommendations on the basis of principles decided by the parliament, and to analyse budget proposals (in particular the use of one-off measures and creative-accounting techniques). The Fiscal Policy Council could also monitor the consistency between national budget proposals and the stability/convergence programmes submitted to the EU. Absent further provisions, the influence of such a Fiscal Policy Council would depend entirely on whether it can over time build up a professional reputation based on its judgements. If given sufficient resources, a council of this type might very well succeed in doing so, but there is also the risk that it just becomes yet another player in the "market" for macroeconomic policy analysis.
2. One way of giving an independent Fiscal Policy Council more "bite" would be to oblige the government to base its annual budget proposal on the forecasts of the council regarding both output growth and tax/expenditure developments. As exhibited in a number of studies, output forecasts underlying budgetary planning have shown a systematic optimism bias in some EU countries where they have been produced by the Ministry of Finance (France, Germany, Italy, Portugal and Luxembourg), while this has not been the case in countries where the forecasts have instead been made by independent agencies (Austria, Belgium and the Netherlands).[147] Hence, such an obligation would make it more difficult for governments to hide fiscal indiscipline behind over optimistic forecasts.

[147] See Larch and Salto (2003), Strauch, Hallerberg and von Hagen (2004), and Jonung and Larch (2004). There seems also to be a correlation between slippage from the fiscal objectives and the degree of optimism bias. Similar results have been found for the US by Auerbach (1994).

3. A way of enhancing the status of the Fiscal Policy Council would be to have it work directly on behalf of the parliament and address reports directly to it. The task of the council could then be both to make recommendations on appropriate fiscal policies as part of the process of preparing the government budget proposal and then, as part of the decision-making process in the parliament, to evaluate the proposal once it has been made. The Fiscal Policy Council should then, of course, also in this set-up base its work on objectives and guidelines decided *ex ante* by the parliament. The government could be obliged to respond formally to the reports of the Fiscal Policy Council. The parliament could commit in advance to holding public hearings, in which the government is confronted with the evaluations of the council. To gain maximum influence it would be crucial that the presentations of the council's evaluations are arranged as a major media event. One way of raising public interest might be to give the Fiscal Policy Council itself the possibility to arrange "reversed hearings" where the independent experts can question policy makers (rather than the other way around) when the evaluations of the council and the government differ fundamentally.
4. One might give the Fiscal Policy Council an even stronger role by directly involving it in decision-making. One could, for example, stipulate that the government should normally follow the recommendations of the council on the size of the annual budget deficit (and possibly also on the level of government expenditure) and that deviations are possible only under exceptional circumstances. One could leave it to the government to judge whether or not prevailing circumstances should be regarded as exceptional, but if it chooses to deviate from the recommendations of the council, it would have to give a formal motivation to the parliament. The latter could in such cases commit to holding public hearings with participation of the government, the council and other experts (possibly also from the European Commission).
5. The most far-reaching step would be to give the Fiscal Policy Council some decision-making power by allowing it to *veto* the budget bill if it is of the view that the budget deficit (or level of expenditures) is inconsistent with the *ex-ante* objectives for fiscal policy decided by the parliament. Preferably, the Fiscal Policy Council should be confined to using the veto only when it considers the government's policy to diverge *fundamentally* from the deficit (or expenditure) targets. A veto from the council should not be absolute, so that it would always be possible for the political system to override it, but at a cost. Such a veto right could be more or less encompassing. A weak veto right might imply that the parliament can always overrule the veto by a renewed single-majority

decision (preferably after a process of public hearings as discussed above). A stronger veto right could require that a renewed parliamentary decision must be taken with a qualified majority if the veto is to be overruled. Alternatively, the requirement for overriding the veto could be that the parliament is dissolved and a renewed parliamentary decision is taken by a newly elected parliament. If the veto is not overruled, the decision of the Fiscal Policy Council on the appropriate size of the budget deficit (and/or on total expenditures) should become legally binding. It would then be up to the parliament to adjust the individual expenditure (and possibly also) tax items accordingly, so the parliament would also in this case retain full control over the main distributional effects of fiscal policy.[148] A potential way of circumventing a veto by the Fiscal Policy Council might, of course, be that the government *ex post* – after a conflict with the council has arisen – tries to change the basic objectives and guidelines for fiscal policy that the council should base its decisions on. To prevent abuse of such an option, one could stipulate in advance that such changes become operational only after a time lag of several years.[149]

Independence of the council

If a Fiscal Policy Council of the type discussed here is to function properly, it must be truly independent of the political system when carrying out its operational tasks. One should follow similar principles as for independent central banks. This means that once the political system has set the objectives and the guidelines for the council, both the government and the parliament should be prohibited from giving instructions to it regarding its operational work. And the council should be prohibited from taking such instructions. Periods of office for council members should be long and non-renewable.

Appointments should require professional competence in the field of macroeconomic policy, which could have been acquired through either earlier work in ministries of finance, central banks, international organisations (such as the IMF, the OECD, the European Commission *etc.*) or academic research. Appointments could be made by the parliament (or a parliamentary committee) on recommendation from an appointment board of professional economists and after public questioning in the parliament (as is the case with appointments of, for example, Fed governors in the US and

[148] See Wyplosz (2002, 2005) for a similar proposal.
[149] This idea is close to a proposal by Kydland and Prescott (1977) in their original article on the time consistency problem of economic policy.

Box 3: Models for a national Fiscal Policy Council

Institutional set-up

- The parliament decides fiscal-policy objectives.
  - Objective for deficit or change of debt over the business cycle
  - Objective for government expenditures
  - Objective and guidelines for the use of fiscal policy as a stabilisation tool
- The parliament appoints a Fiscal Policy Council on recommendation from a professional recruitment committee and after public questioning of candidates.
  - Requirements of professional competence.
  - Long, non-renewable and overlapping terms of office.
  - Prohibition for government to give and for council to take instructions.

Annual fiscal policy decision-making process

(1) The council prepares forecasts and gives policy recommendations to the government.

(2) The government proposes the budget bill – based on the council's forecasts – to the parliament. Deviations from the council's recommendations have to be motivated.

(3) The council evaluates the consistency of the budget bill with the *ex-ante* objectives set by the parliament.

(4) The government responds to the council's evaluation.

(5) Public hearing followed by a budget debate in the parliament.

<table>
<tr><td rowspan="2">Soft option
(6) Parliamentary decision</td><td colspan="2">Hard option
(6) Parliamentary decision
(7) Veto by the council if major discrepancy between budget bill and ex-ante objectives</td></tr>
<tr><td>(8) Veto stands
(9) The parliament adjusts government expenditures and/or taxes to attain the deficit decided by the council.</td><td>(8) Veto is overruled by the parliament. Possible models:
(i) New single-majority decision in the same parliament.
(ii) New qualified-majority decision in the same parliament.
(iii) Dissolution of the parliament and new single-majority decision in newly elected parliament.</td></tr>
</table>

Safeguards of the system

- *Ex-ante* objectives can only be changed by the parliament after a time lag.
- Regular *ex-post* evaluation of the council's performance by professional evaluation committee appointed *ex ante.* Dismissal of council possible if:

(i) major failure of the council to carry out its tasks;
(ii) recommendation from professional evaluation committee; and
(iii) qualified majority in the parliament.

members of the Executive Board of the ECB). To avoid the situation whereby all appointments are made by the same political majority, the periods of office of the council members should be overlapping.

Comparison with earlier proposals
In recent years, a number of proposals on various types of Fiscal Policy Councils have been made by economists. Some of them have not argued only for such councils to advise, monitor or constrain government policies, but also for *delegation* of parts of actual fiscal policy making. Usually the proposals have focused on the stabilisation role of fiscal policy only. A common proposal has been to delegate the right to raise or lower specific tax rates within pre-determined margins around some politically decided base level in order to stabilise the business cycle.[150] The aim has been to increase the effectiveness of stabilisation policy by reducing time lags and the risk that stabilisation motives are confounded with other objectives. On the one hand, the proposals in this essay are wider in scope since they focus on the overall size of the budget deficit (and possibly also on expenditure levels) in various phases of the business cycle. But on the other hand, the proposals are more limited as they serve mainly to increase the constraints on political decision-making. They do not involve delegation of actual decision-making except in proposal 5 above in the case of a fundamental divergence between actual government policies and pre-set objectives. But also in this case it will always be possible for the political system to override a decision by the Fiscal Policy Council.

Proposals on more "technocratic influence" over fiscal policy are controversial. To the extent that there have been reactions from politicians, they have been dismissive. This is as expected since the aim is to constrain the actions of politicians, which may limit the possibilities to favour the own constituency and to gain political support through the use of fiscal policy. The proposals do, however, raise fundamental questions about the principles of democratic decision-making. Critics have argued that the freedom of action of democratically elected politicians would be circumscribed in an unacceptable way.[151] However, such criticism misses the main point: the proposals are designed to counteract distortions in the political process and promote policies that are better aligned with the preferences of citizens. An optimally designed decision-making system should take account of possible biases in the political process and set up countervailing constraints.

[150] See, for example, Ball (1997), Business Council of Australia (1999), Seidman (2001), EEAG (2003, 2004) and Calmfors (2003a,b).
[151] See, for example, *Ekonomiska utsikter* (2005).

Technocratic versus political decision-making

In any democratic political system, there are complex issues of where to draw the line between political and technocratic (bureaucratic) decision-making.[152] With political decision-making, elected representatives make the decisions. Technocratic decision-making implies instead that appointed technocrats make the decisions guided by *ex-ante* objectives set by the political system. Both types of decision making have advantages and disadvantages. One advantage of political decision-making is that decision makers can be held directly accountable by voters. A disadvantage is that electoral concerns, lobbying, excessive discounting of the future and time inconsistency problems can lead to short-sighted, opportunistic behaviour, which reduces social welfare. With technocratic decision-making, policy makers cannot be held directly accountable by voters, but career concerns give strong incentives to exercise competence when trying to fulfil the goals of the bodies entrusted with carrying out specific tasks. These goals may, however, be influenced by idiosyncratic concerns and to a lesser or larger degree differ from the politically decided objectives.

The institutional design problem is to find the most appropriate allocation between political and technocratic decision-making. This allocation problem concerns both which types of decision-making should dominate in various policy areas and at what level the line between political and technocratic decision-making should be drawn within each policy area (where the operational conduct of policies is always at some level delegated to technocrats).[153] As concerns differences among policy areas, it is today common in most developed countries to delegate tasks like conduct of monetary policy, supervision of financial markets, regulation of competition, administration of active labour market policy as well as the conduct of rescue, police and military operations to technocratic decision-making, But in other areas, such as foreign and fiscal policy, the degree of political control is much higher in most countries.

The appropriate allocation between political and technocratic decision-making depends on the character of tasks.[154] Technocratic decision-making is in general more appropriate when decisions require a high degree of professional competence and careful processing of information, when objectives are possible to specify clearly *ex ante*, and when the political

[152] The subsequent discussion draws heavily on Majone (1996), Blinder (1997), EEAG (2003), Calmfors (2003a,b) and Alesina and Tabellini (2004).

[153] Notably, both administrative and judicial decisions regarding individuals are almost invariably delegated to bureaucrats to ensure equal treatment.

[154] See, in particular, Alesina and Tabellini (2004).

process is likely to be distorted by time inconsistency problems and lobbying by small, but powerful, vested interests that have large stakes in the outcome. Political decision-making is more effective when professional competence is less important and when it is difficult in advance to specify objectives, either because they are so complex that instructions would have to be very detailed or when the preferences of the citizens change over time. Another strong argument for political decision-making is when there are important policy complementarities, so that the success of one policy depends crucially on other policies as well (one example is pension reform, which may require budget deficits in the short run in order to achieve a desired distribution of income across generations).[155]

Thinking along these lines, it is not clear why it is desirable to delegate monetary policy to independent central banks, but not to increase the influence of independent experts over fiscal policy. Indeed, the area of fiscal policy exhibits many of the characteristics that could motivate such reforms. As has been evidenced by my discussion, problems of short-sightedness and opportunistic behaviour are common in the fiscal policy area. Evaluating the effects of various fiscal policy decisions on budget deficits and on macroeconomic performance requires professional competence and careful processing of information. It would seem possible to specify fiscal policy objectives clearly already *ex ante*. From a purely theoretical point of view, there appear to be as strong arguments in favour of fundamental changes in the structure of fiscal policy decision-making as there are for depoliticising monetary policy.

The functioning of the democratic system

The establishment of the most far-reaching variants of a Fiscal Policy Council (with some form of veto power) in European countries could not, of course, be evaluated only on its merits for the technical efficiency of fiscal policy. Such reforms would have much wider ramifications for how our systems of parliamentary democracy work. A full analysis of this is beyond the scope of this essay. But it is obvious that changes of this type could be a significant move in the direction of a more US-like system, where division of power among different institutions and "checks and balances" play a much more important role than has usually been the case in Europe.

The establishment of an influential Fiscal Policy Council would raise fundamental issues regarding the involvement of citizens in the democratic process and the legitimacy of decisions taken. One could see it as a risk

[155] See Section 3.3.2 above.

that citizens might be less interested in the political process – with lower voting turn-out as one possible consequence – if the link between voting and (some of the) fiscal-policy decisions becomes less direct. If so, the legitimacy of these decisions might be weakened. But, on the other hand, a council of the proposed type would enhance transparency of fiscal policy and make it easier for voters to evaluate the consequences of various policies. If a Fiscal Policy Council were to veto a deficit with the motivation that it is not consistent with earlier decided objectives, the government would have either to explain why it is of another view before a new parliamentary decision overriding the veto is taken or to openly seek a revision in the parliament of the objectives for fiscal policy in such a way that citizens could form an opinion on the issue. This should be regarded as a democratic gain, which would serve to increase the legitimacy of the fiscal policy decision-making process.

It would, of course, be naive to believe that independent experts in a Fiscal Policy Council would not be influenced by political considerations. They certainly would, just as the judges in the US Supreme Court are. But the point is that "technocrats" are likely to be *significantly less* politically motivated than elected politicians. Provided that the council members would have to be recruited on the basis of professional competence, the desire to maintain their reputation among their "peers" would act as a strong force constraining politically motivated behaviour. In the literature on monetary policy, it has been observed that also central bankers with a political background tend to "internalise" the traditional objectives of central banks once they represent them. This has been labelled the *Thomas-Becket effect*.[156] A similar effect might operate with a Fiscal Policy Council.

If an independent Fiscal Policy Council were to play a larger role in national fiscal policy making, problems of accountability need to be addressed. One should decide in advance on *ex-post* evaluation procedures and there should be a possibility for the parliament to fire the council if it does a poor job. But this possibility should be heavily restricted not to compromise the independence of the council: dismissal should be possible only if the council has failed in a major way to carry out its tasks and it should require a recommendation from a professional examining committee as well as a qualified majority in the parliament.

[156] See Goodman (1989) or Berger and de Haan (1997). Thomas Becket was Chancellor and a good friend of the English 12th century king Henry II. Becket's appointment as Archbishop of Canterbury was heavily criticized by the clergy, who feared that the independence of the church would be jeopardised. But once Archbishop, Thomas Becket turned into a staunch defender of the independence of the church. This eventually led to his being murdered by four of the king's knights.

A possible objection to giving an independent Fiscal Policy Council more say over fiscal policy is that the responsibility for macroeconomic outcomes might become more blurred. Already today, the macroeconomic performance of an EU country depends on the actions of two policy makers: the government, which is responsible for fiscal policy as well as labour and product market regulations, and the monetary authority (the ECB or the national central bank), which is responsible for monetary policy. At least according to the more far-reaching proposals above, the establishment of a Fiscal Policy Council would add a third decision maker able to influence macroeconomic performance. One might argue that this would make it more difficult to hold policy makers accountable. But a counter argument is that the assignment of well-defined tasks to independent bodies would make it easier to "nail down" mistakes in the specific policy area than if a government is at the same time held accountable for its performance in a large number of areas through the ordinary political process.[157]

A short-run versus a long-run perspective

Are independent national Fiscal Policy Councils a realistic option? The answer may depend on the time perspective. In the short run, the answer is most certainly no. Politicians are not likely to give up some of their control over fiscal policy. This applies in particular to the EU countries with the least fiscal discipline. But politicians in other EU countries are likely to react in a similar way. Another obstacle is the absence of existing blueprints in practical use.

However, in a longer time perspective, matters could turn out differently. If fiscal discipline in Europe breaks down because of the failure of the fiscal rules at the EU level, there will emerge a need to put something else in their place. This will in all probability have to be done at the national level. The hope would be that some countries start experimenting with new institutions for fiscal policy making and that successful countries could set examples for others to follow (as happened with modern central banking).[158] One could see this as an application of the *open method of co-ordination* used in some areas of EU co-operation, such as employment policy,

[157] This point has been argued by Majone (1996) in particular.

[158] Another option would be to try to agree on common principles for national Fiscal Policy Councils at the EU level (just as there are common rules for the independence of national central banks). This has been proposed by EEAG (2003) and Wyplosz (2005). In my judgement, this is not likely to be feasible, for similar reasons as those given above. And even if it were feasible, it is probably not appropriate, as rules on more technocratic national institutions imposed by the EU are almost certain to meet with grave problems of legitimacy.

where the objective is to exploit policy differences among member states to identify “best-practice solutions”.[159]

However, even at best, the establishment of new structures for fiscal policy making at the national level, which could serve as a substitute for the watered-down rules at the EU level, will be a time-consuming process. It is not likely to gain momentum until after further fiscal policy failures. So, the best forecast is that fiscal policies in most EU countries will have to get worse before they can get better.

[159] See, for example, von Hagen and Mundschenk (2001).

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SVENSK SAMMANFATTNING

Stabilitetspakten, som utgör en central del av EU:s finanspolitiska regelverk, reviderades tidigare i år (2005). Detta skedde efter ett antal överträdelser av de tidigare reglerna. Frankrike, Tyskland och Grekland har stått för de mest uppmärksammade regelbrotten. Men också Italien, Portugal och Storbritannien bland de gamla EU-länderna och Cypern, Malta, Polen, Slovakien, Tjeckien och Ungern bland de nya har för närvarande större budgetunderskott än tillåtet. En central fråga är hur den finanspolitiska disciplinen i EU-länderna kommer att påverkas av förändringarna i stabilitetspakten.

Förändringarna innebär att toleransen för budgetunderskott ökar. Budgetunderskott över tre procent av BNP blir tillåtna under fler omständigheter och tidsfristerna för att minska underskotten blir längre än tidigare. Den viktigaste förändringen är att man radikalt vidgar utrymmet för beslut från fall till fall (*diskretionära* beslut) om hur höga underskott som kan tillåtas. Reglerna blir därmed mycket otydligare. Det framstår som ytterst osäkert om sanktionssystemet med depositioner och böter för länder med alltför stora underskott någonsin kommer att användas. I varje fall tycks de nya reglerna tillåta budgetunderskott över tre procent av BNP i mellan sex och nio år innan böter kommer att bli aktuella. Men det allvarligaste problemet är förmodligen inte de formella revideringar som gjorts i stabilitetspakten, utan att man har visat att reglerna anpassas till de regelbrott som sker. Detta äventyrar trovärdigheten också för de nya reglerna.

Reformen av stabilitetspakten innebär att spärrarna mot stora budgetunderskott i EU-länderna försvagas kraftigt. Detta är mycket allvarligt, eftersom det i moderna demokratier tycks finnas en stark inneboende tendens till alltför stor offentlig skuldsättning (en ”deficit bias” enligt anglosachsisk terminologi). Det kan bero på att finanspolitiken görs alltför expansiv inför val (politiska konjunkturcykler), att enskilda intressegrupper bedriver ”lobbying” för utgiftsökningar eller skattesänkningar som gynnar den egna gruppen utan att tillräckligt beakta effekterna på samhällsekonomin som helhet (”allmänningarnas tragedi”), att politiska partier som riskerar att förlora makten passar på att gynna de egna väljarna så länge man sitter i regeringsställning (strategiskt beteende) och att en regering lätt kan frestas att försöka uppnå kortsiktiga ekonomisk-politiska mål även när detta innebär höga långsiktiga kostnader (tidsinkonsistensproblemet).

Tendenserna till hög offentlig skuldsättning kan väntas vara särskilt starka inom euro-området, eftersom en gemensam valuta innebär att en del av kostnaderna i form av effekter på räntor, växelkurs och inflation kan över-

vältras på andra länder. Försvagningen av stabilitetspakten innebär därför en betydande risk för en återgång till tidigare mönster av bristande finanspolitisk disciplin i många EU-länder. Man kan få en process där budgetunderskott och växande offentlig skuldsättning ”smittar” mellan länderna. Stora budgetunderskott kommer i det långa loppet att medföra en rad problem: en icke önskvärd omfördelning av inkomster och konsumtion över tiden och mellan generationer, räntehöjningar och drastiska åtstramningar av finanspolitiken med stora negativa välfärdseffekter när budgetproblemen till slut måste åtgärdas. I värsta fall kan också hela EMU-projektet hotas om en växande offentlig skuldsättning i euro-länderna skulle leda till en inflationsprocess.

Hur allvarliga konsekvenserna av stabilitetspaktens försvagning blir, kommer att bero på hur de reviderade reglerna tillämpas under de närmaste åren. Hanteringen av de stora budgetunderskotten i framför allt Frankrike, Tyskland och Grekland kommer att bestämma framtida praxis. En fortsatt mjuk behandling av dessa länder skulle skicka en signal om att EU:s finanspolitiska regelverk i praktiken har monterats ner. Om man vill begränsa försvagningen av stabilitetspakten, krävs en strikt tillämpning av reglerna. Sanktioner, i form av depositioner och eventuellt böter, måste tillgripas mot Frankrike, Tyskland och Grekland om inte dessa länders budgetunderskott snabbt minskas till under tre procent av BNP. Tyvärr är en sådan strikt tillämpning av regelsystemet osannolik, eftersom samma krafter som ledde till det tidigare regelverkets sammanbrott fortfarande verkar.

Det största problemet med den tidigare stabilitetspakten var inte brister i reglernas ekonomiska innehåll utan oförmågan att se till att reglerna efterlevdes. Det berodde i sin tur på att incitamenten att använda sig av sanktionsmöjligheterna i regelverket är svaga. En fungerande stabilitetspakt kräver att dessa incitament förstärks. En möjlighet vore att överföra sanktionsbesluten från Ekofin-rådet (EU:s finansministrar) till EG-domstolen. En annan möjlighet vore att försöka öka sannolikheten för att Ekofin-rådet verkligen ska använda sig av sanktionsmöjligheterna. Det skulle kräva förändringar av följande slag:

- Länder med otillåtet stora budgetunderskott bör inte få rösta i förfarandena mot andra länder med alltför stora underskott. Det skulle minska risken för koalitioner mellan länder med otillåtna underskott i syfte att blockera sanktioner.
- Lägre depositions- och bötesbelopp till en början vid otillåtet stora budgetunderskott skulle göra sanktionerna till mindre av en ”atombomb”. Det skulle minska det politiska motståndet mot att tillgripa sanktioner.

- Svagare finansiella sanktioner skulle kunna kompletteras med icke-finansiella sanktioner. En möjlighet vore att länder med otillåtet stora budgetunderskott successivt över tiden skulle förlora en del av sina röster i Ekofin-rådet (i alla frågor som beslutas där) till dess att underskotten rättats till. Till skillnad från böter skulle en sådan sanktion inte ytterligare förvärra budgetunderskotten.

Dessvärre är reformer av detta slag osannolika, i varje fall under lång tid framöver. Politikerna vill förmodligen undvika att fortsatta försök förändra stabilitetspakten ska leda till ytterligare politiska konflikter mellan EU:s medlemsstater. Med den osäkerhet som för närvarande råder om den föreslagna konstitutionen är reformer som kräver fördragsändringar (som ändrade rösträttsregler) knappast aktuella. Man måste därför hitta andra vägar att upprätthålla den finanspolitiska disciplinen i EU:s medlemsstater.

En möjlighet skulle kunna vara att en *mindre grupp* av EU-länder bildar en *pakt för finanspolitsk uthållighet* (en ”fiscal sustainability pact”) med striktare finanspolitiska krav än enligt den reviderade stabilitetspakten. En sådan ”uthållighetspakt” (eller ”disciplinpakt”) skulle antingen kunna utnyttja de formella möjligheter till så kallat *förstärkt samarbete* mellan vissa medlemsländer som det nuvarande EU-fördraget ger eller också utgöra ett mer informellt samarbete där man försöker samordna reformer på nationell nivå. Lämpliga kandidater att ingå i en sådan uthållighetspakt skulle vara de länder som varit mest finanspolitiskt disciplinerade och försökt slå vakt om de tidigare reglerna: Belgien, Danmark, Estland, Finland, Nederländerna, Spanien, Sverige och Österrike. Andra möjliga kandidater skulle eventuellt kunna vara Irland bland de gamla medlemsländerna och Lettland, Litauen och Slovenien bland de nya.

En finanspolitisk uthållighetspakt skulle kunna innehålla åtaganden om både formella procedurer och faktisk budgetpolitik. Åtagandena om procedurer skulle syfta till att stärka sambandet mellan de finanspolitiska besluten på EU- och nationell nivå. Deltagarna skulle kunna förplikta sig till att låta både Kommissionen och Ekofin-rådet presentera sina utvärderingar av den nationella finanspolitiken, både inom ramen för den ömsesidiga övervakningen (”multilateral surveillance” och förfarandet vid alltför stora underskott (”excessive deficit procedure”) i de nationella parlamenten. Dessa skulle sedan hålla offentliga utskottsutfrågningar och debatter på grundval av utvärderingarna. Sådana åtaganden skulle kunna ses som en uppföljning av förslag i överenskommelsen mellan EU:s finansministrar om reformerna av stabilitetspakten. I fråga om den faktiska finanspolitiken skulle deltagarländerna till exempel kunna förplikta sig att inte utnyttja den reviderade stabilitetspaktens möjligheter till förlängda tidsfrister för att rät-

ta till otillåtna budgetunderskott annat än i extrema situationer. Det skulle innebära att otillåtna budgetunderskott måste rättas till året efter det att de upptäckts, vilket var den ursprungliga tanken bakom stabilitetspakten. Budgetunderskott under tre procent av BNP under viss tid skulle också kunna krävas för att få delta i uthållighetspakten.

Ett förstärkt finanspolitiskt samarbete, som omfattar endast en mindre grupp av EU-länder, skulle både förstärka incitamenten för budgetdisciplin i deltagarländerna och kunna tjäna som ett föredöme för de andra länderna. Men ett sådant samarbete skulle också kunna ha vidare effekter. Det skulle kunna bidra till EU:s utveckling i stort genom att ge ett konkret exempel på *flexibel integration* (genom ett fördjupat samarbete i en ”okonventionell” grupp av medlemsländer). En invändning mot ett sådant fördjupat samarbete på det finanspolitiska området kan dock vara att det kanske inte skulle ha tillräcklig *legitimitet*, eftersom många medborgare i EU-länderna tycks ha upplevt att integrationsprocessen gått alltför fort. Det kan också finnas ett starkt politiskt motstånd mot ett förstärkt finanspolitiskt samarbete som bara skulle omfatta vissa länder: andra länder skulle kunna motsätta sig detta, eftersom det ännu tydligare än idag skulle pekat ut dem som ”finanspolitiskt odisciplinerade”. Det är vidare möjligt att mindre EU-länder – som enligt mitt förslag är de som kan komma ifråga för ett fördjupat finanspolitiskt samarbete – skulle dra sig för att på detta sätt ”provocera” de större EU-länderna. Det finns också den allmänna synpunkten att en flexibel integration skulle kunna äventyra sammanhållningen inom EU som helhet.

En helt annan väg att motverka de negativa effekterna av stabilitetspaktens försvagning vore att i stället förstärka de *nationella finanspolitiska institutioner* som kan främja budgetdisciplin. Detta skulle kunna ses som en naturlig följd av en utveckling som visat att det inte finns tillräcklig legitimitet för att upprätthålla finanspolitiska regler på europeisk nivå. Ett lämpligt nationellt finanspolitiskt ramverk bör innehålla åtminstone tre komponenter: (i) i förväg fastställda och väldefinierade mål (för budgetsaldo eller den offentliga sektorns skuldutveckling över konjunkturcykeln, för de offentliga utgifternas nivå och för stabilisering av konjunkturtvecklingen); (ii) ett åtagande om en *transparent* (genomskinlig) *budgetprocess* som undviker engångsåtgärder och ”kreativ bokföring” syftande till att dölja det verkliga budgetutfallet och som tydligt skiljer mellan permanenta utgifts- och skatteförändringar och tillfälliga sådana av stabiliseringspolitisk karaktär; och (iii) *incitament* för regeringen att utforma finanspolitiken så att den står i överensstämmelse med de i förväg fastställda målen. En nyckelroll bör spelas av ett nationellt *finanspolitiskt råd*, bestående av oberoende experter, med uppgift att övervaka regeringens politik.

Syftet med ett sådant oberoende finanspolitiskt råd skulle vara att *begränsa* regeringens möjligheter att genom beslut från fall till fall avvika från sina egna långsiktiga mål. Tanken är att motverka att olika ”snedvridningar” i den politiska processen ska leda till en politik som inte ligger i den politiska majoritetens eget intresse.

Man kan tänka sig mer eller mindre långtgående befogenheter för ett finanspolitiskt råd, alltifrån att ta fram ekonomisk-politiskt beslutsunderlag till att involveras i det direkta beslutsfattandet. Regeringen skulle kunna åläggas att basera sina budgetkalkyler på det finanspolitiska rådets prognoser. En annan möjlighet vore att låta budgetprocessen starta med rekommendationer från rådet: regeringen skulle sedan vara tvungen att motivera eventuella avvikelser från dessa inför parlamentet. Ett ännu mer långtgående förslag vore att ge det finanspolitiska rådet *vetorätt* mot parlamentsbeslut om det årliga budgetsaldot (och eventuellt också de offentliga utgifternas nivå), om det anser att besluten strider mot de övergripande finanspolitiska mål som parlamentet självt formulerat. Ett sådant veto skulle inte vara absolut, men det skulle kunna undanröjas bara om särskilda krav är uppfyllda: det skulle till exempel kunna krävas ett nytt beslut av samma parlament (med enkel eller möjligen kvalificerad majoritet) eller också nyval och ett nytt beslut av det nya parlamentet.

Förslaget om nationella finanspolitiska råd aktualiserar fundamentala frågor om var gränsen ska dras mellan politiska beslut och tjänstemannabeslut (där förstås tjänstemannabesluten ska fattas på grundval av de mål och riktlinjer som ställts upp av det politiska systemet). Vilken typ av beslutsfattande som är mest lämpligt på ett visst område beror på ett antal kriterier. Beslutsfattande av tjänstemän (oberoende experter) kan vara lämpligt när det krävs expertkompetens och noggrann analys av komplicerad information, när det går att i förväg tydligt precisera målen och när den politiska processen karakteriseras av en hög grad av kortsiktighet. Politiskt beslutsfattande är önskvärt när kraven på expertkompetens är lägre, när det är svårt att i förväg precisera målen, när risken är stor att tjänstemännen ska vägledas av sina egna i stället för av de politiskt bestämda målen och när effekterna av åtgärder på olika områden har starka ömsesidiga effekter (det vill säga när effekterna av politiken på ett område i hög grad beror på hur väl den kan samordnas med politiken på andra områden). Utgår man från dessa kritier, förefaller det finnas väl så starka argument för att ge ett oberoende finanspolitiskt expertråd inflytande på delar av finanspolitiken (budgetsaldo och offentlig utgiftsnivå) som för att delegera penningpolitiken till en oberoende centralbank.

Det skulle vara *teoretiskt* möjligt att på EU-nivå komma överens om gemensamma riktlinjer om nationella finanspolitiska institutioner av det slag som skisseras här. Men det vore inte möjligt *i praktiken*. Orsaken är att sådana förslag är mycket kontroversiella. EU-initiativ som syftar till ett större teknokratiskt inflytande över politiken skulle sannolikt öka många medborgares skepsis mot EU. Förslag om förändrade nationella finanspolitiska institutioner måste därför baseras på nationella erfarenheter: vill man ha mer av expertinflytande över finanspolitiken, finns det ingen väg förbi en utdragen nationell debatt, där det gäller att övertyga medborgarna om att sådana förändringar ligger i deras intresse.

Om stabilitetspaktens försvagning leder till ökande budgetunderskott i EU-länderna, är förmodligen det bästa man kan hoppas på att enskilda länder börjar experimentera med nya former för det finanspolitiska beslutsfattandet. Lyckade reformer skulle då kunna tjäna som förebilder för andra länder. Detta skulle kunna ses som en tillämpning av de så kallade *öppna samordningsmetoder* som används på vissa områden av EU-samarbetet, till exempel sysselsättningspolitiken, där man utifrån olika länders erfarenheter försöker identifiera ”best-practice solutions”. Tyvärr är denna slutsats inte särskilt optimistisk, eftersom den innebär att det kan ta lång tid att ersätta den delvis nedmonterade stabilitetspakten med andra incitament för finanspolitisk disciplin. Det förefaller därför troligt att budgetsituationen i många EU-länder kommer att förvärras kraftigt innan den kan förbättras.

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