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ABSTRACT

The Stability Pact Pains: A Forward-Looking Assessment of the Reform Debate*

The Stability and Growth Pact has been under fire ever since it was born. But is the Pact a flawed fiscal rule? Against established criteria for an ideal fiscal rule, its design and compliance mechanisms show strengths and weaknesses. The latter tend to reflect trade-offs typical of supra-national arrangements. In the end, only a higher degree of fiscal integration would remove the inflexibility inherent in the recourse to predefined budgetary rules. No alternative solution put forward in the literature appears clearly superior. This does not mean that the original Pact of 1997 could not be improved. The debate on the SGP has shown that any reform should aim at overcoming the excessive uniformity of the rules, improving their transparency, correcting pro-cyclicality and strengthening enforcement. The reform of the Pact agreed in 2005 moves in this direction but leaves open a number of issues.

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1. Introduction

The Stability and Growth Pact (SGP) is one of the pillars of EMU. It is a discipline device aiming at ensuring sound budgetary balances and low public debts. Being widely regarded as a major innovation (Artis, 2002), the Pact has been the subject of a heated controversy ever since its inception. It has been extensively criticised by academics and opinion makers. Proposals for radical changes have been put forward and even the suppression of the Pact has been considered.

This debate accelerated in 2002 under the influence of public finance developments in a number of euro area countries, which called into question the effectiveness (and wisdom) of the Pact. The crisis mainly reflected the lack of improvement in structural budget positions in the late 1990s and early 2000s and the impact of the subsequent downturn. This pushed the deficits of several countries towards or above the 3% of GDP deficit ceiling.

The pace of events heightened in the aftermath of the November 2003 decision by the Council not to follow the European Commission recommendations concerning the excessive deficit procedures applying to France and Germany, which had deficits exceeding the 3% limit since 2002. Some countries supported the Commission's view. This laid open the differences in opinions and interests among European institutions and Member States. Following a request by the Commission, in July 2004 the European Court of Justice gave its judgement concerning this contrast. The bottom line of the judgement is that EU fiscal rules can work smoothly only if the Council and the Commission co-operate.

In September 2004 the Commission put forward a number of proposed changes to the SGP with the aim of avoiding pro-cyclical policies; better defining the medium-term objective; giving greater prominence to the debt criterion; considering economic circumstances in the implementation of the excessive deficit procedure; and improving governance and enforcement (European Commission, 2004b).

After a difficult and at times heated debate, an agreement was reached at the ECOFIN Council of March 2005 in a report which envisaged changes to both the preventive and corrective arms of the Pact (Council, 2005).

This debate has taken place against the background of unsatisfactory fiscal outcomes. A budgetary behaviour inconsistent with the requirements of the SGP occurred especially in large countries. Since 2002 France and Germany have deficits largely exceeding 3% of GDP. Following sizeable statistical revisions, in 2004 it was revealed that Greece had systematically exceeded the limit since 1997; though by a small amount, in 2005 it became clear that Italy had exceeded the limit in 2001, 2003 and 2004. Also Portugal breached the deficit ceiling by a wide margin in 2005. Other countries have temporarily exceeded the limit or have budget deficits that are clearly inconsistent with the close-to-balance clause of the SGP. Moreover, some countries have made recourse to one-off measures or to new accounting and financial operations, which, even if formally consistent with EMU rules, do not improve the underlying public finance conditions (European Commission, 2004a and 2005).

In a way, these developments are related to the success of EMU rules in curbing deficits in earlier years. When in the late 1980s and early 1990s the public finances of several EU countries appeared to be on an unsustainable path, the benefits of lower deficits were evident. Fiscal discipline was recognised as a pre-condition to lower interest rates and to use fiscal policy for cyclical stabilisation (Buti, Franco and Ongena, 1998). Even an arbitrary target such as the 3% of GDP deficit limit was deemed desirable because it forced countries to undertake the inevitable adjustment. As soon as the budgetary situation improved, the issue of the proper balance between fiscal discipline and other targets came to the fore. The move to EMU radically changed the structure of incentives faced by EU governments, lowering the relative weight of abiding by common rules compared to other, more domestic objectives (Buti and Giudice, 2002).

This paper evaluates the critical aspects of EMU fiscal rules, considers the main reform proposals and assesses the changes introduced in the Pact in 2005. The outline is as follows. Section 2 reviews the critical issues in the implementation of the SGP and the main proposals put forward to replace or radically revise the Pact. Section 3 draws some implications of the debate on the SGP in the light of recent the literature on fiscal rules. Section 4 considers the changes in the SGP agreed in 2005 and their possible impact on its functioning and effectiveness. The final section concludes.

2. Revisiting the SGP: critical issues and reform proposals

According to its critics, the 1997 Stability Pact had several shortcomings: it reduced budgetary flexibility, worked asymmetrically, was too uniform, did not sanction politically-motivated fiscal policies, discouraged public investment, disregarded the euro area-wide fiscal stance, and ignored long term sustainability.

In this context several proposals have been put forward for replacing or modifying the Pact. One way or another, all the proposals draw on one or more of the above criticisms. A summary of the main proposals put forward mainly by academics to replace, reform or improve the SGP is presented in Table 1.[1]

Table 1. Reforming the SGP: main proposals

Critical issue	**Reform proposals**	**Authors**	**Institutional implications**
Numerical rules do not tackle at source the budgetary misbehaviour; SGP needs a more credible and non-partisan enforcement.	Reform national institutions: - change budgetary procedures - create independent FPCs Strengthen financial market discipline	Buiter and Siebert (2005) Eichengreen (2003) Fatàs et al (2003) Wren-Lewis (2003) Wyplosz (2002, 2005)	Reform the Treaty, abolish Excessive Deficit Procedure. Amend Large Exposure Directive. Change rules about collateral in ECB open market operations
The SGP pays too much attention to the budget deficit, not to the quality of public finances.	Factor in the "quality of public finances: - expenditure rules - golden rule	Blanchard and Giavazzi (2003) Brunila (2002) Fitoussi and Creel (2002) Mills and Quinet (2002)	Institutionalisation of the golden rule requires changes in the Treaty.
Sustainability depends on the stock of debt and future stream of expenditure and revenue, not on the short run deficit.	Focus on debt and sustainability: - Debt Sustainability Pact - Permanent Balance Rule - diversified deficit ceiling	Buiter and Grafe (2003) Calmfors and Corsetti (2002) Coeuré and Pisani-Ferry (2003) Gros (2003) Pisani-Ferry (2002)	These proposals require changes in the Treaty.
The SGP does not address the issue of the appropriate fiscal stance for the euro area as a whole.	Fiscal policy coordination at euro area level: - aggregate budget balance target - tradable deficit permits	Bofinger (2004) Casella (2001) Schelkle (2002)	Within a national 3% ceiling, not incompatible with the Treaty.

[1] Adapted and updated from Buti et al. (2003a). See also Begg and Schelkle (2004).

2.1 Reform national procedures and institutions

The first-best strategy in ensuring sound fiscal policies would be that of dealing directly with the factors leading to excessive deficits at the national level. This would avoid relying on numerical parameters which are necessarily arbitrary and subject to fudging[2]. Fiscal policy soundness would be ensured either by procedures assuring fiscal responsibility at the national level or by market discipline[3]. This strategy answers to the criticism concerning the lack of budgetary flexibility.

Two sets of proposals come under this heading.

Procedural reforms - Procedural reforms impose changes on the rules concerning the presentation, adoption and execution of government budgets. Hierarchical procedures are more conducive to fiscal discipline than collegial procedures. At the national level, hierarchical rules attribute strong power to treasury ministers to overrule spending ministers during the intra-governmental preparation of the budget and limit the ability of the parliament to amend the government's budget proposals.

Replacing the numerical limits with procedures ensuring sound budgetary positions would raise two problems. First, there is still a need for transparent and rapid criteria for selecting new entrants to the euro area. Second, the adoption of harmonised budgetary procedures would raise problems from the point of view of national sovereignty and might conflict with national institutions and traditions. The alternative solution - country-specific procedures approved at EU level - would also be cumbersome. The ex ante effectiveness of these procedures would be very difficult to evaluate. Moreover, in case they did not prove effective in constraining deficits, the attribution of responsibility would be difficult as national governments might argue that they had conducted their fiscal policy in compliance with the agreed procedures.

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[2] Strong evidence of the widespread used of one-off measures and creative accounting in the early year of EMU is found by Koen and van den Noord (2005). See also von Hagen and Wollf (2005).

[3] The possibility of relying on market mechanisms to provide effective incentives to fiscal discipline was assessed in depth in the late 1980s when the EMU was designed. It was widely considered that the constraints imposed by market forces are either too slow and weak or too sudden and disruptive. More recent work confirms that market mechanisms cannot be relied upon for replacing fiscal rules. However, greater transparency in fiscal accounts can allow markets to usefully complements rules. See Balassone et al. (2004). For a survey of the proposals aiming at strengthening financial market discipline see Buti et al. (2003a). The issue has been recently raised again by Buiter and Siebert (2005).

In the end, while effective budgetary procedures are important in ensuring sound fiscal policies at the national level,[4] they do not appear at present to be a viable alternative to numerical rules at the EU level. However, some procedural rules (such as common accounting conventions) are called upon to ensure compliance with the budget constraints.

Institutional reforms – Under this heading, the proposal that has attracted most attention is that of creating independent Fiscal Policy Committees (FPC). This idea draws on the experience of central banks running monetary policy. In the strongest versions, such bodies would be given the responsibility for setting the budget balance targets (Wyplosz, 2002, 2005) or even be responsible for some specific tax rates (Wren-Lewis, 2003).

While intellectually appealing, these proposals run into serious feasibility problems. Fiscal policy is - differently from monetary policy - at the heart of the political decision-making process. The separation between setting a target for the budget balance (to be entrusted to the FPC) and the allocative and distributive functions (to remain in the responsibility of government and parliament) may turn out to be difficult. Decisions about the budget balance affect the composition of expenditure and revenues. Politically, it is hard to conceive that a government would delegate part of fiscal policy authority to an independent agency. In a softer version (Sapir et al. 2004; Annet et al., 2005), however, such bodies could be entrusted with the task of monitoring and assessing policy proposals and decisions thereby improving visibility and transparency.[5] As such, however, they appear more as a complement than as a substitute for numerical rules.

2.2 Factoring in the "quality" of public finances

The SGP focuses on the yearly budget balance. However, a growing body of literature points out that the composition of public finances matters as well. The focus on quality has been translated into two proposals for reforming the SGP: shifting from a deficit target to (a) an *expenditure target/rule* or moving to (b) the so-called *golden rule* of deficit financing.

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[4] Actually, the Treaty Protocol on the Excessive Deficit Procedure calls upon Member States to ensure the consistency of national procedures and institutions with the provisions of the Treaty.

[5] While most proposals suggest to introduce FPCs at national level, Fatás et al. (2003) propose to create such a body at the EU level.

Expenditure rules - Focus on expenditure has the advantage of controllability because expenditure depends much less than revenue on the business cycle. Expenditure rules can link the annual budgetary process to a multi-annual policy framework. They refer to the budgetary items that governments can control and can be easily defined and monitored. Moreover, they allow stabilisers to work on the revenue side and may prevent expenditure relaxation in upturns.

The use of expenditure rules in a supranational context (see section 3), however, appears problematic. First, uniform spending rules would *de facto* impose homogeneous social preferences to politically heterogeneous countries while country-specific rules would be difficult to enforce. Second, spending norms do not refer to the fiscal variables which can produce negative externalities: while a rising deficit or debt level in one country can create area-wide problems, a rising expenditure level as such does not have negative repercussions on other countries. Moreover, expenditure rules cannot prevent deficit and debt increases stemming from tax cuts. Therefore, they would have to be complemented by a deficit or debt rule. Third, since no uniform expenditure to GDP ratio can be prescribed, countries would be required to indicate targets for the expenditure ratio consistent with the desired deficit ratio. Finally, the size of the budget typically reflects the political preferences of the government. A new government may want to renegotiate the commitments of its predecessor.

In sum, while expenditure rules may prove useful at the national level, they are more appropriate as complements rather than substitutes of common rules on deficits and debt.

The golden rule - A number of authors have suggested to replace the SGP by some form of golden rule (Blanchard and Giavazzi, 2003). The golden rule would allow spreading the burden of capital projects over the different generations of taxpayers benefiting from them and would avoid the efficiency loss caused by distortionary taxation if the tax rate fluctuates over time. This would answer to some criticisms expressed against the SGP. In fact, maintaining budget positions “close to balance or in surplus” implies that capital expenditure will have to be funded from current revenues which may imply a disincentive to undertake projects producing deferred benefits. The disincentive is stronger during consolidation periods.

However, there are a number of arguments against the introduction of the golden rule (Balassone and Franco, 2000a; and Buiter, 2001).

First, the alleged incompatibility between the SGP and a properly defined golden rule is questionable. In order to spread the burden of capital spending over the different generations of taxpayers, the rule would have to refer to net spending. In developed countries in which infrastructures are partly developed by subjects not included in general government, the level of net investment is limited and not necessarily inconsistent with a reasonable interpretation of the close-to-balance rule of the SGP (European Commission, 2004a). *Second,*, if applied to gross public investment, the golden rule would be an obstacle to deficit and debt reduction. Given the ratio of public investment as a percentage of GDP, the long-run equilibrium level of government debt could be quite high, especially in an environment of low inflation. *Third*, singling out public investment from other budget items makes little sense. What is important is overall capital accumulation in both private and public capital. For instance, a well-devised tax reform that, by lowering tax burden and distortions, leads to higher investment may be preferable to public investment. Also, there is no clear evidence in the empirical literature that investment in public infrastructure always leads to significant positive growth effects. Some studies suggest that government investment may be subject to rapidly decreasing returns (see, e.g. de la Fuente, 1997). Moreover, a golden rule may distort expenditure decisions in favour of physical assets and against spending on intangibles that can make a relevant contribution to economic growth, for example those increasing human capital. *Fourth*, the golden rule would make the multilateral surveillance process more complex, by providing leeway for opportunistic behaviour since governments would have an incentive to classify current expenditure as capital spending. *Finally,* there are problems of cross-country comparability of the data concerning amortisation.

On top of that, there is no guarantee that government investment would increase as a result of the introduction of the golden rule. This occurs only if public investment is kept under the desired level because of the ceiling to the overall deficit, while the same does not occur for current expenditure. It may be the case that by introducing a golden rule the additional room for deficits is used to increase current expenditure (or cut taxes) without an impact on investment (see Turrini, 2004).

2.3 Focus on debt level and sustainability

The Treaty rules do not focus on the issue of sustainability and disregard the fact that countries are different. This criticism has different nuances. First, the SGP focuses almost exclusively on short term objectives for the budget deficit. As such, it provides incentives

for creative accounting and one-off measures which blur the transparency of public accounts. Second, the stock of public debt does not enter the SGP and neither do the stock of implicit liabilities of public pension systems. Hence, the Pact treats equally countries with different medium and long-term prospects and different debt levels. Third, the Pact may prevent countries from implementing policies – such as pension reforms which improve long term sustainability at the price of a short term worsening in the deficit.[6]

Two solutions have been put forward in the literature: the first is to compute a medium term target that factors in directly country-specific sustainability concerns; the second is to give more weight to the public debt in the common rules.

From the Maastricht parameters to tax smoothing – It has been argued that the SGP is over-restrictive and too crude to deliver the appropriate fiscal stance at national level (Allsopp and Artis, 2003). The Pact is particularly unfit in the case of catching up countries which are characterised by higher potential growth and higher inflation, and hence can afford to have higher deficits without endangering the long term sustainability of public finances. Given the higher public investment needs of less mature economies, a rigid application of the close-to-balance *cum* 3% ceiling could allegedly harm the catching up process.

Buiter and Grafe (2003) propose a Permanent Balance Rule which would ensure sustainability and fiscal prudence while taking into account country differences. Their rule is a strong form of tax smoothing: it requires that the inflation-and-real-growth adjusted permanent government budget is in balance or surplus. The permanent budget balance is given by the difference between the constant long run average future values of tax revenue and government spending.

While the rule is theoretically appealing, by requiring to take into account future social and political preferences and make assumptions on future growth rates for the calculation of the permanent value of taxes and expenditures, its practical applicability appears doubtful (Pench, 2003). Moreover, considering the need to ensure creditworthiness and strong macro-financial stability to attract FDI, the argument that catching up would necessarily be fostered by allowing higher deficits is debatable (European Commission, 2005).

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[6] For a theoretical model, see Razin and Sadka (2002).

More weight on the public debt - A way to overcome the uniformity of the Pact is to attribute more importance to public debt. Calmfors and Corsetti (2002) suggest to make the deficit ceiling dependent on the stock of debt: the deficit ceiling of 3% of GDP should be binding only for countries with a debt ratio in excess of 55% of GDP while a higher ceiling would apply to countries with lower debt. This proposal respects the requirement of simplicity while improving incentives and country differentiation. It would be "enlargement-friendly" as most of the newcomers have a fairly low stock of debt. However, it would require a change in the Treaty.

Tackling the issue head on, Pisani-Ferry (2002) and Coeuré and Pisani-Ferry (2003) suggest giving countries with debt ratios below 50% of GDP the choice of opting out of the Excessive Deficit Procedure and embrace a so-called Debt Sustainability Pact. These countries would be required to submit a medium term programme indicating a five year target for the debt ratio and presenting a complete account of implicit liabilities, which would represent the benchmark for assessing their results. They would have greater flexibility in the short term. The focus of EU monitoring would shift from the year-by-year monitoring of the deficit to a medium term perspective based on long term fiscal sustainability.

This proposal, however, is also somewhat problematic. First, it is built on the assumption that deficits do not matter in EMU if debt levels are under control. This however is doubtful, especially from a policy mix standpoint. Second, while greater reference to the debt ratio does not raise measurement problems, reference to implicit liabilities is more problematic. Estimates are subject to considerable uncertainty related to the macroeconomic, demographic and behavioural scenarios (see section 4).

Nonetheless, disregard of the issue of public debt is a clear limitation of the original SGP.

2.4 Fiscal policy coordination at the euro area level

This category of reform proposals envisages fiscal co-ordination at the euro area level. In a currency union, only the aggregate fiscal stance is relevant for the policy mix at the euro area level and, as such, enters the reaction function of the central bank. Hence it is suggested to set a target for the euro area as a whole and then share it between member countries.

These solutions answer the allegation that SGP disregards the aggregate fiscal stance. Under the Pact, each country is responsible for national fiscal policies and the

aggregation of nationally-determined fiscal policies may not result in an optimal fiscal stance at the euro area level.

Fiscal coordination can be achieved either via community-level decisions indicating the desirable budget balance of each country or a market-based allocation of national deficit shares of the total euro area deficit.

Community allocation of deficit shares - A proposal for a coordination mechanism in the budgetary domain was submitted by the French Finance Minister, Dominique Strauss-Khan, at the informal Ecofin Council in April 1999. The proposal stressed that the aggregate policy stance at the EMU level must be examined on the basis of an aggregate stability programme. It pointed out that the objective to achieve an adequate policy stance for EMU as a whole should be taken into account when examining the national stability programmes.[7]

A natural implication of this is that the 3% of GDP deficit criterion would only apply to the average deficit for the euro area. Member States would be permitted to overshoot the deficit ceiling if there were other countries with deficits below that value. Since the amplitude of cyclical fluctuations is much smaller for the euro-zone as a whole, the targets needed to prevent an overshooting of the aggregate deficit ceiling would be less stringent than those necessary for each Member State individually.

However, in the present institutional set-up of EMU the deficit criterion applies to each Member State individually. The Maastricht budgetary rules would thus have to be renegotiated in order to allow this interpretation to be implemented. Moreover, bureaucratic allocation of deficit shares would be highly controversial.

Market allocation of deficit permits - Casella (2001) proposes to use market mechanisms in the allocation of “deficit shares” in EMU. Having chosen an aggregate target for the Union and an initial distribution of tradable deficit permits, EMU countries could be allowed to trade rights to deficit creation. While this system keeps the aggregate area-wide deficit unchanged, it allows individual Member States to deviate from the initial allowances in case of idiosyncratic shocks.

The mechanism would minimise the aggregate cost of compliance with the aggregate targets and provide rewards for countries running surpluses in favourable cyclical

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[7] Similar proposals have been put forward lately by Bofinger (2004) and Schelkle (2002).

conditions thereby tackling the issue of the asymmetric working of the Pact. It would also reduce the room for political manipulation.

This scheme is subject, however, to three main difficulties. First, the market solution would be efficient only if the deficits of the various governments generate the same externality, i.e. they are perfect substitutes. But the risk of triggering a financial crisis is not uniform across governments. Second, the efficiency of the market in permits depends on how competitive it is. This makes the mechanism ill suited to situations in which the number of governments is small. Finally, there is no easy solution to the problem of determining the initial allotment of permits. The possible criteria (GDP, population, etc.) would produce greatly differing allocations.

3 Lessons from the debate

Each of the proposals examined above draws the attention to one or more potentially serious problems with the design and implementation of the SGP. The suggestion to implement institutional and procedural reform highlights the need for an independent enforcer. The idea to move to a golden rule stresses the need to preserve the growth aspect of the SGP. A number of proposals highlight the excessive uniformity of the current rules. Taking into account the different levels of public debt points to the need to insert the sustainability dimension into the core of the SGP. The proposal of establishing a market for deficit permits tackles the problem of the pro-cyclical bias in good times.

However, none of the proposals represents a 'Pareto improvement': while appropriate to tackle some of the problems highlighted in the debate, none of them solves all problems and some problems may even be aggravated. Certain reform proposals present the same element of inflexibility of the current regime (golden rule); others require estimates which may turn out problematic in a multinational context (debt sustainability pact, permanent balance rule); others again require a decisive leap forward in the integration of fiscal policy (procedural reforms, budgetary target for euro area).

In evaluating the SGP, one should also consider the indications provided by the literature concerning the role and design of fiscal rules. The role of fiscal institutions and procedures in shaping budgetary outcomes has been increasingly recognised. While "good rules" do not necessarily entail "good policies", inadequate budgetary institutions and procedures may contribute to a lack of fiscal discipline.

In previous papers (Buti et al., 2003a and b), we have analysed the "quality" of EU fiscal rules in terms of the criteria identified by Kopits and Symansky (1998) and Inman (1996) for the design, implementation and enforcement of a fiscal rule. A good fiscal rule should be well-designed (clearly defined, simple, transparent, consistent and flexible), allow effective implementation (by entailing ex ante and ex post compliance and efficient monitoring) and be enforceable (in terms of decision, amendment and sanctions).

Our conclusion was that the SGP has strong points – in particular as regards to simplicity and monitoring – and weak points – namely concerning enforcement. Lack of effective enforcement de facto shifts the Pact in the realm of 'soft law' (Schuknecht, 2004). However, in order to pass a judgement on the 'quality' of the SGP as a fiscal rule, one has to consider that the criteria discussed in the literature were devised for assessing the quality of domestic fiscal rules. With EMU for the first time fiscal rules had to be devised in a supra-national context.

EMU fiscal rules reflect the interaction between the multinational nature of EMU and the lack of a political authority of federal rank (Balassone and Franco, 2001). This has important implications. First, national sovereignty and subsidiarity concerns had to be respected. This implies that rules are to be as neutral as possible vis-à-vis the countries social preferences which are quite heterogeneous in the EU. This prevented, for instance, the adoption of rules which entail a choice of the role and size of the public sector in the economy.

Second, in a supra-national context, ex post compliance is important, given the higher risks of moral hazard and the higher difficulty in monitoring ex ante policy announcements.

Third, the supra-national character influences the trade-offs between the various criteria in complex ways. Take the trade off between simplicity and flexibility. On the one hand, there may be a preference for simplicity over flexibility to allow peer pressure, central monitoring and prevent moral hazard. On the other hand, a multiplicity of countries increases heterogeneity and dispersion of preferences with the consequence that a one-size-fits-all fiscal rule is likely to be sub-optimal[8].

Finally, since imposing formal sanctions on sovereign countries raises political difficulties, one should strengthen the role of reputational effects, such as those of 'early warnings' and

[8] This trade off will be sharpened by the enlargement of the euro area to new Member States. For a discussion, see Orbán and Szapáry (2004).

excessive deficit positions, also via increased fiscal transparency, and limit the recourse to sanctions to cases of serious misbehaviour.

While no proposal appear adequate as a ready-made alternative to the SGP, the debate has pointed to a number of key areas where improvement of the original Pact could be made. In our view (Buti et al., 2003a and b), key aspects are (a) overcoming excessive uniformity of the rules, by allowing a certain country-specificity with respect to structural and cyclical economic factors; this would increase the economic foundations of the rules; (b) improving transparency in current and perspective fiscal accounts; this would ensure the credibility of the rules and strengthen market and political mechanisms of deficit control; (c) correcting pro-cyclicality, by re-balancing incentive schemes with a view to avoiding misbehaviour especially in good times; and (d) strengthening enforcement by moving towards a non-partisan application of the rules.[9]

In the following section, after briefly outlining its main features, we assess how the SGP reform agreed in 2005 fares vis-à-vis such objectives.

4. Revisiting the SGP: enter the policy makers

4.1 The new SGP

While the debate in academic circles showed the depth of the divisions among economists, a certain consensus gradually emerged in the course of 2004 among the main policy players as to what changes were needed to the EMU fiscal framework. It was recognised that EMU needed numerical fiscal rules (since financial market discipline and national procedures were not deemed sufficient to ensure budgetary discipline) and that any radical changes to the rules introduced in 1992 (Maastricht Treaty) and 1997 (SGP) would be highly problematic. "Internal adjustment" of the existing framework rather than a radical overhaul of the rules came to be regarded as the only feasible way ahead. It was also acknowledged that complementary measures at the national level (such as better budgetary procedures and independent fiscal councils) would be highly desirable. The common menu of internal reforms included action to improve fiscal policy in good times,

[9] As emphasised in the debate on fiscal rules, there are trade offs and complementarities between the desired features of a 'good' rule. For instance enhancing country-specificity is likely to lead to less transparency, while improving the latter is likely to lead to more effective enforcement. For a discussion, with a particular reference to supra-national rules, see Buti et al.(2003).

more consideration of public debt and long-term sustainability in assessing Member States' budgetary positions, a greater focus on cyclical developments and more transparency in fiscal data. Other aspects were more controversial: these included changes to the excessive deficit procedure and a stronger role for the Commission as enforcing agency.

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

At the request of the European Council, in September 2004 the Commission issued a Communication suggesting a number of more changes to the Pact which, while preserving its overall architecture, aimed at avoiding pro-cyclical policies, especially in good times; better defined the medium-term objective by taking into account country-specific circumstances and reforms; gave greater prominence to the debt criterion; modify the implementation of the excessive deficit procedure, in particular by allowing more time to correct an excessive deficit under certain circumstances; and improved governance and enforcement (European Commission, 2004b).

After a difficult and at times heated debate, an agreement was reached at the ECOFIN Council of March 2005. The guidelines of the reform were set out in a report which envisaged changes to both the preventive and corrective arms of the Pact (Council, 2005).[10]

On the preventive side (i.e. the medium-term targets and the adjustment path towards them), medium-term budgetary objectives are now to be somewhat differentiated from one country to another on the basis of debt ratios and potential growth rates. Targets will be specified in structural terms, i.e. cyclically-adjusted and net of the effects of temporary

[10] These changes where subsequently translated into legislative amendments of the SGP regulations in July 2005. For a detailed presentation of the new Pact, see European Commission (2005).

measures, and will range between a deficit of 1% of GDP and a small surplus. The latter would apply to high-debt, slow-growth countries. Implicit liabilities will also be taken into account in the future, once further technical allows the Council to agree on criteria and methodological aspects. Major structural reforms with long-term fiscal benefits will be taken into consideration both when defining the adjustment path towards the medium-term objective and when considering temporary deviations from the target. A more articulated set of provisions concern also the path towards the medium term objectives, though a minimum annual adjustment of 0.5% of GDP has to be ensured.

On the corrective side (i.e. the application of the Excessive Deficit Procedure), a modification was introduced in the definition of the "exceptional cyclical circumstances" which may justify the reference value for the deficit being exceeded: a breach of the threshold will now be considered exceptional if it results from a negative growth rate or an accumulated loss of output during a protracted period of very low growth relative to potential growth. When evaluating deficits exceeding the 3% limit, the Commission will take into account a number of factors ranging from cyclical conditions to the implementation of the Lisbon agenda and policies to foster R&D and innovation, from debt sustainability to the overall quality of public finances, from financial contributions to international solidarity to fiscal burdens related to European unification. However, any excess over the 3% deficit threshold should remain limited and temporary. The implementation of pension reforms establishing a compulsory funded pillar will also be taken into consideration, especially when assessing whether an excessive deficit has been corrected.[11]

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

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

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[11] See Schuknecht and Tanzi (2005), who suggest that country circumstances and reform design matter.

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

4.2 An evaluation of the reform

These changes had a mixed reception. Some commentators argued that, given the host of exceptions to the 3% rule, the Pact is *de facto* dead. Others considered the proposals to be an important step forward in achieving a better balance in the Pact between fiscal discipline and flexibility. The same divisions that animated the debate on the original SGP surfaced again in the reactions to its reform.

The review of the debate on the SGP has highlighted the critical issues that any effective reform of the Pact should tackle. As argued above, any reform of the rules should aim at (a) overcoming excessive uniformity, (b) improving transparency, (c) correcting pro-cyclicality, and (d) strengthening enforcement.

Table 2 provides a qualitative assessment of the main changes introduced by the Council in the governance of the new rules, the preventive and the corrective arm of the SGP.[12] In the rest of this section, we provide a first assessment of the 2005 reform and give some indications on where further progress is needed to ensure the effectiveness of the new rules.

[12] For earlier assessments of the reform, see the Postscript in Buti and Franco (2005), Eijffinger (2005) and European Commission (2005).

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

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

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

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

The Council has taken a cautious approach by stipulating that, in order to safeguard the 3% deficit ceiling, the medium term target should never exceed a deficit 1% of GDP.[13] This implies that countries with relatively low stock of debt and estimated implicit liabilities will be allowed to have cyclically-adjusted budget deficits up to 1% of GDP. This solution is consistent, in most cases, with a prudent version of the golden rule.[14] The debt ratios in high debt countries and in countries with expected rising expenditure levels would decline fast, thereby contributing to offset the burden of ageing in the future, while in the other countries deficit levels would ensure the maintenance of a small public debt. The solution would strengthen the political incentives to reduce the current and implicit debt at a faster pace.

In order to avoid moral hazard, commonly agreed estimates of implicit liabilities in EU countries would have to be computed, following the experience of the Economic Policy Committee's estimates of age-related public spending (EPC, 2003). The use of long-term projections in the EU fiscal framework should be conditional on progress

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[13] According to the European Commission estimates, these margins would be adequate for the larger countries. See European Commission (2002).

[14] As pointed out above, in the case of public investment, the right concept is that of *net* investment (hence taking into account amortisation).

concerning the comparability, transparency and independence of the projections. A variety of sustainability indicators could be used: tax-gaps, government net worth, and generational accounting. Since each indicator requires some arbitrary choices, it will be necessary to predefine the relevant assumptions and parameters and agree on a common set of indicators.[15]

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

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

As to the first aspect, the EU fiscal framework has been widely criticised for a lack of transparency.[16] This issue has different facets. First, the deficit indicator as defined by ESA-95 does not provide a full picture of countries' public finance imbalances. Second, the debt indicator (gross financial debt at face value) allows targets to be achieved via operations which do not improve fiscal sustainability and tends to underestimate overall outstanding liabilities. Third, under the current system of national accounts, monitoring is hampered by delays in data provision and allows some manipulation of statistics with the implication that the whistle is often blown far too late or only when the true data eventually surface. Finally, the forecasts underlying stability programmes have frequently turned out to be optimistically biased.

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

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[15] See Balassone and Franco (2000b) and the other essays in Banca d'Italia (2000).

[16] See Balassone Franco and Zotteri (2005), Koen and van den Noord (2005) and von Hagen and Wolff (2004).

In recent years, in order to meet the short term targets, countries have frequently adopted one-off, cash-raising measures instead of making the necessary structural adjustment. The decision that compliance with the medium term target as well as with the minimum annual adjustment of 0.5% of GDP are to be assessed in *structural* terms, by netting out the estimated effect of the cycle and one-off measures, will lead to improved transparency.[17] In order to implement this, an agreed definition of one-off measures could complement the existing agreement on how to compute cyclically-adjusted balances.[18] However, given the current legislation and accounting conventions, the 3% rule has not been modified. Hence, in practice, one-off measures can still be used at the margin to avoid an excessive deficit. As to the abrogation of an excessive deficit, it will be important to focus on the *durability* of the adjustment, thereby reducing the incentives to use one-off measures to temporarily bring the deficit below the reference value without correcting the underlying imbalances.

As to public debt, the application of the fiscal rules will continue to focus on its definition in *gross* terms. However, this overlooks the fact that government assets can be sold to repay the debt and that there are non-financial liabilities. Relying on both a gross and a net debt definition is preferable. The former is more precise, timely available and more relevant over the short term; the latter is more complete and relevant from a longer time perspective. On the basis of an agreed and transparent framework, governments could be required to provide estimates of off-budget liabilities, of their net asset position and of long-term budgetary trends.[19] Estimates should be revised every year and changes extensively explained.

The availability of high quality statistics and timely fiscal indicators still remain an issue. The problem of early detection of deviations from targets was vividly exposed in the case of Portugal in 2001. Even more serious has been the case of Greece, which in

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[17] This will extend the experience of 2000-2001 with the UMTS proceeds to all temporary measures.

[18] The estimation of cyclically adjusted figures and one-off measures raise technical problems and require some decisions concerning methodological solutions. Moreover, cyclically adjusted balances can be revised ex post on the basis of new information concerning the macroeconomic outlook. Public spending normally reflects several measures and events with temporary expansionary or restrictive effects. It may probably be useful to consider only the measures having transitory effects on public revenues (e.g. sales of assets, anticipation of tax payments, tax amnesties). Guidelines concerning the definition of one-off measures would have to be agreed in advance. For a tentative taxonomy of one-off measures, see European Commission (2004a).

[19] See Balassone, Franco and Zotteri (2005). A first step in this direction is represented by introduction of long-term expenditure projections in the stability programmes.

2004 turned out to have had a deficit in excess of 3% of GDP since 1997. In this, but also in other countries, the yearly increase in public debt has frequently exceeded the deficit level as below-the-line operations have systematically contributed to debt growth.

The new Pact acknowledges the importance of quality, timeliness and reliability of fiscal statistics and pledges to ensure the independence, integrity and accountability of both national statistical offices and Eurostat.[20] The availability of better statistics should be complemented a more comprehensive surveillance of fiscal variables. A way forward is to resurrect, in parallel with national accounts definitions, regular monitoring of cash flows. National authorities could be required to indicate ex ante cash figures broadly consistent with the ESA95 balance. In parallel, changes in the debt level (net of the effects of exchange rate changes and privatisation proceeds) could be closely monitored[21]: if a significant departure from target is detected in financial flows, it would be up to national authorities to explain the difference.[22]

Overly optimistic forecasts that are common in some Member States[23] can translate into higher than projected deficits, since government revenues quickly respond to changes in potential output whereas adjustments on the expenditure side normally require a lengthy process of political decision-making. The new Pact indicates that budgetary projections should be based on realistic and cautious macroeconomic forecasts. European Commission (2004b) proposed that stability programmes should be based on macroeconomic assumptions provided by the Commission. The Council decided that countries are still free to use their own assumptions, but they should explain in detail divergences with respect to the Commission forecasts.[24]

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20 On the importance of a reliable statistical framework for the application of EU fiscal rules, see Balassone, Franco and Zotteri (2003).

21 See Balassone, Franco and Zotteri (2005) and European Commission (2005).

22 As proposed by the Commission, in the cases of application of the Excessive Deficit Procedure to Greece, Portugal and Italy in 2005, the recommendation on issued by the Council included a mention on avoiding reliance on below-the-line operations.

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

24 The case for independent forecasts is advocated by Jonung and Larch (2004).

While the above changes go in the direction of improving the quality and availability of fiscal indicators, others are likely to negatively affect the second aspect of transparency mentioned above, that is the possibility to easily assess compliance with the rules.

As to the corrective part of the Pact, the most notable amendment is the specification of so-called "other relevant factors" in the assessment of whether a deficit in excess of 3% of GDP can be considered 'excessive' in the sense of the Treaty. Such factors - ranging from the implementation of the Lisbon agenda and policies to foster R&D and innovation to the overall quality of public finances, from financial contributions to international solidarity to fiscal burdens related to European unification – may give countries easy escape roads in the case of deficits in excess of the reference value. While there is an important safeguard in the provision that any excess over the 3% deficit threshold should remain limited and temporary, encompassing such long list of factors, risks blurring the assessment.

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

Correcting pro-cyclicality - It is widely recognised that the original SGP did not provide sufficient incentives for countries to run prudent fiscal policies in good times with the result of having their room for manoeuvre curtailed in bad times. The new agreement explicitly aims at correcting pro-cyclicality by emphasizing the important of reliable macroeconomic forecasts, the commitment to step up consolidation in good times, relaxing the "exceptionality clause", making the timing for the correction of the excessive deficit a function of the prevailing cyclical conditions and foreseen the guarded possibility to repeat steps of the procedure in case of adverse shocks.

While these changes go in the right direction, one may ask whether they go far enough in terms of stick and carrots.

In order to step up peer pressure, a possible solution could be that of using the early warning procedure of the SGP not only in bad times when the deficit approaches the 3% ceiling, but also in good times when a significant divergence from structural targets is detected. The idea of an early warning procedure independent of the immediate danger of an excessive deficit is considered in European Commission (2004b). However, the

new SGP, while foreseen the possibility for the Commission to issue "policy advice" in this regard, did not accept this proposal.

Buti et al. (2003a and b) and Sapir et al. (2004) have argued that he introduction of rainy-day funds may improve the incentives for a prudent fiscal behaviour in good times. These funds, which would be used in times of recession and replenished in upturns, might increase the incentive for governments not to waste the surpluses in good times and increase the room for manoeuvre in bad times. However, their establishment would imply a review of the current ESA accounting rules for computing budgetary statistics, so although interesting, such a move is not unproblematic. [25]

Strengthening enforcement - A strong criticism of the Treaty and the old SGP is that enforcement is partisan: national authorities are supposed to apply the rules to themselves, thereby having strong incentives for collusion and horse-trading.

As indicated in table 2, similarly to the case of transparency, the new Pact includes provisions which will strengthen enforcement and others which are likely to weaken it further.

As pointed out in Buti et al. (2003a and b), enforcement is particularly problematic in the case of supra-national fiscal rules applying to sovereign countries. A way forward would be to enhance the national ownership of the rules so that there is a better chance that they become self-enforcing[26]. In parallel, one should strengthen the role of the Commission in the enforcement of the SGP.

On the first count (national ownership), the new provisions concerning governance – notably the involvement of national parliaments - go in the right direction, but are overall modest. In particular, the suggestion to establish independent monitoring bodies at national level (see table 1), which was mentioned in the initial proposals by the Commission (European Commission, 2004b), was not accepted. On the second count (stronger role of the Commission), the new Pact does not introduce any significant change in the voting or the procedural arrangements. Evidently, the Council was not

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[25] Alternatively, the Treaty protocol could be revised, mentioning that the 3% reference value refers to budget balances net of accumulation of assets in the rainy-day fund. However, an issue arises when the fund is depleted after protracted deficits: the budget balance figure used in the SGP would quickly worsens leading to difficulties in the implementation of the SGP.

prepared to strengthen the authority of the Commission in the interest of the credibility of EU fiscal rules. On the contrary, provisions such as the considerations of "other relevant factors", by reducing transparency and increasing the possibility of collusion in the Council, risk working against an effective enforcement of the rules.

An overall view – All in all, can the reform be considered an improvement on the original Pact? We can answer this either by comparing the new with the old provisions, or by also considering the process which has lead to the new framework. In the first case, one can conclude that some elements of the reform improve the quality of the EU budgetary framework while others worsen it.

Some innovations allow greater flexibility in dealing with special circumstances and country-specific problems, while retaining a prudent approach to fiscal behaviour as flexibility will remain bounded by the provision that any excess over 3% of GDP has to remain temporary and limited and no category of spending is excluded from the definition of the deficit. The steps being considered to improve fiscal transparency, enhance the quality of statistics and strengthen national budgetary institutions can reinforce the rules. The emphasis on long-term sustainability makes the fiscal rules less myopic, a criticism often levelled at the old Pact. The revision of the exceptionality clause is positive in that it removes an excessively restrictive condition.

On the other hand, some changes may be more problematic. This is the case for the extended deadlines for correcting deficits which may risk becoming a moving target. The greater complexity of the new framework may lower the visibility of the fiscal targets and make monitoring less effective. As the literature stresses, complex and less clearly defined rules are more difficult to enforce. There are also a number of controversial technical issues that remain to be addressed, such as how sustainability is to be measured, how temporary measures are to be defined, how the quality of public finances is to be assessed, and how to account for the cost of European integration. Finally, little changes have been introduced in the key provisions affecting enforceability of the rules.

In other areas, further progress is warranted. This applies to the provisions concerning governance (reliable forecasts, role of national Parliaments, continuity over the

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[26] As argued in Buti and Pench (2004) and shown by the experience of the early years of EMU, this is particularly important in the case of large euro area countries where the threat of external sanctions is less effective.

legislature), to the definition of the satisfactory pace of debt reduction and the development and implementation of a broader set of fiscal indicators. In due course, to increase coherence and visibility, one could resurrect the initial suggestion by the Commission to establish a "European semester", where the broad orientations for fiscal policy are agreed, followed by a "national semester" where such general orientations are translated in concrete policy actions.

If we take the second approach to assessing the reform, the process that has led to the reform gives rise to certain unease, since the changes may be interpreted as having been designed to accommodate the specific fiscal difficulties of well-identified countries. Clearly, the ideal would be to set or reform rules under a "veil of ignorance", without knowing in advance who the winners and losers would be. However, the vacuum created by the de facto suspension of the rules following the ECOFIN decision of November 2003 demanded a policy response from the European institutions.

5. Conclusions

This paper has taken the view that the current EU fiscal framework should be examined in the light of the theoretical and empirical work on fiscal rules, but encompassing its supra-national nature. The framework aims at balancing fiscal discipline and fiscal stabilisation in a context in which countries ultimately remain responsible for national fiscal policy..

Clearly, the Stability Pact 'mark I' had a number of drawbacks - particularly in terms of asymmetric incentives and lack of a long-term view. The reformed Pact goes some way towards correcting such problems while retaining the original architecture. But, in the end, the major weakness of the old rules was poor enforcement mechanisms. Will the new rules be more effectively enforced? The fact that in the new Pact there is a greater margin for discretion but no independent enforcer may increase the incentives for collusion by the Council in subverting the implementation of the rules. If so, lack of enforcement would persist or even be aggravated. However, as the new Pact encompasses better economic rationale and may improve national ownership and fiscal transparency, there may be a better chance that it becomes self-enforcing.

Whatever judgement is ultimately made regarding the revision of the SGP, it would be wrong to assume that the Pact will become irrelevant. First, the reasons why fiscal rules

were adopted in a monetary union of many sovereign countries in the first place are still valid. The future enlargement of the euro area to Central and Eastern European countries actually strengthens the need for a common fiscal framework. Second, as shown by the debate on the reform of the Pact, no viable alternative to a credible supranational rule emerged, since all the other potential solutions came up against serious criticism of one kind or another. Third, many countries need sound fiscal policies leading to a reduction in debt levels also for purely domestic reasons – particularly the demographic shock which lies around the corner: an external anchor may continue to be useful. Finally, it is likely that, as soon as serious imbalances emerge in some countries threatening the stability of the euro area, the other euro-area members will step up the pressure for rigorous implementation of the rules.

Therefore, in our view, the SGP will not become "yet another EU coordination process" that, after a burst of attention, fades away and de facto be forgotten. On the contrary, as rules are necessary in a monetary union, but as such put a constraint on national choices, it can safely be predicted that the revised Pact will remain at the core of policy debate in Europe. And there will be no shortage of proposals for the "reform of the reform".

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