PDP/05/2

IMF Policy Discussion Paper

Reforming the Stability and Growth Pact

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INTERNATIONAL MONETARY FUND

 PDP/05/2

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European Department

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February 2005

Abstract

A rules-based fiscal framework, such as the EU's Stability and Growth Pact (SGP), can be an important bulwark against short-sighted policies. Although policies have improved following the SGP's adoption, shortcomings remain. These, however, are rooted in the policies rather than the rules, where few changes seem necessary. Specifically, the Excessive Deficit Procedure needs a stronger focus on policies rather than outcomes, while staying operationally simple and transparent. Furthermore, reforms are needed to foster time-consistent national policies, budgetary transparency, and ownership of the Pact. Accordingly, parliaments should debate national Stability Programs and national fiscal councils should review these programs for parliaments.

JEL Classification Numbers: E61, E62, H60

Keywords: Fiscal policy, fiscal rules, political economy

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I. Introduction and Summary

The record of the Stability and Growth Pact (SGP), the European Union's (EU) five-year old fiscal framework, has prompted calls for its reform. While many countries used the framework to place their fiscal policies on a sound medium-term basis, others did not and became entangled in its legal procedures. After five years of experience, the European Commission has been charged with developing reform proposals for the ECOFIN Council.

This paper discusses the fiscal framework of the Economic and Monetary Union (EMU), reviews the experience with the SGP, and offers guidance on the best way forward. In this, the language of the Maastricht treaty—including the 3 percent and 60 percent reference ratios—is taken as given. Section II recalls the main features of EMU's fiscal framework. Section III argues that fiscal rules are important to stem time-inconsistent, short-sighted policies and to coordinate policies across countries in a currency union. Section IV reviews the design of EMU's fiscal framework, concluding that it basically meets the requirements of a model fiscal rule but that some limited adjustments would be useful. Section V argues that policies have improved following the adoption of the SGP, but that they continue to fall short of requirements, owing mainly to deficiencies in enforcement (particularly during upswings) and ownership of the Pact. Section VI presents the principles that should guide SGP reform.

In a nutshell, weighing both economic considerations and political economy concerns, we see no case for major changes to Europe's fiscal rules. There is scope, however, for some limited reforms that could improve their operation. On the specifics, we see no compelling case for rewriting SGP regulations that call for "close to balance or in surplus" (CBS) fiscal targets over the medium run; the present legal text offers sufficient flexibility to accommodate country-specific concerns. Furthermore, the basic design of the Excessive Deficit Procedure (EDP) is appropriate but its operation could be improved by providing more flexibility in setting deadlines, to better distinguish policies (defined narrowly to refer exclusively to budgetary policies) from economic circumstances. Additionally, the debt criterion in the EDP should be made operational. However, any changes to EDP procedures should not compromise their operational simplicity and transparency. Perhaps most importantly, the national Stability Programs should be debated formally in the context of the national budgets.

This would strengthen their authority, with beneficial effects on ownership and enforcement over the medium run. Otherwise, we see no case for changes to EMU's fiscal framework.

However, attaining the framework's objectives will require further reforms that foster time-consistent policies by strengthening enforcement and ownership, particularly through greater transparency and national accountability. This issue transcends the SGP reform debate. As regards strengthened ownership, there is particular merit in the creation of national fiscal councils that report to national parliaments. Such councils would review Stability Programs and should help address the transparency problems that have surfaced in various guises across different countries—problems which led to overly-optimistic assumptions, reliance on one-off measures, creative accounting, and even misreporting. Institutions that help stem nontransparent budgetary practices are already in place in several euro-area countries. But for them to play the role of fiscal councils some fundamental changes will be required. In the meantime, both the European Commission and Eurostat would have to be given more weight in vetting projections, assumptions, and reporting practices.

The stakes are high because rewriting the rules at the current juncture might enshrine rather than address the time inconsistencies in fiscal policies. Indeed, some of the proposals in circulation—such as softening deficit targets to accommodate structural reforms or excluding certain expenditure items from the deficit target—threaten the credibility of the Pact. For the reforms of the Pact to be successful, they must be both transparent and operationally simple, with all member countries committed to abide by not only the letter but also the spirit of the new rules.

II. Bird's eye view of the Stability and Growth Pact

The SGP fleshes out the provisions of the Maastricht Treaty. It consists of a two-pronged fiscal framework—a preventive arm focusing on multilateral surveillance and the avoidance of excessive deficits, and a dissuasive arm tackling "excessive deficits" once they arise. Specifically:

- The preventive arm urges countries to keep their budgets at CBS over the medium run. It emphasizes peer-driven multilateral surveillance and softer forms of economic policy coordination, including through opinions on annual Stability Programs issued by the ECOFIN Council (which comprises national finance ministers), and possibly the use of early warnings.

- The dissuasive arm is charged with ensuring that countries respect the limits on deficits and debt laid down by the Maastricht Treaty—3 percent and 60 percent of GDP respectively. Noncomplying countries are subject to increasingly stringent surveillance under the EDP, which may eventually lead to sanctions (Box 1).

While the preventive arm deals with maintaining a sound fiscal policy, the dissuasive arm addresses gross policy mistakes. The CBS rule is meant to ensure that the 3 percent limit is not broken repeatedly. It does not specify a precise fiscal target that each country has to respect, although it has been interpreted as ruling out deficits that are systematically larger than ½ percent of GDP over the cycle, the idea being to provide a sufficient cyclical safety margin to allow full operation of automatic stabilizers during downturns without breaching the 3 percent reference value. As befits the complexities involved in monitoring compliance with the CBS rule over the cycle, its enforcement is subject to "soft law". "Hard law" enforcement, including fines under the EDP, is tied to gross policy mistakes, namely repeated breaches of the 3 percent limit. Such breaches would lead to unsustainable debt paths because most countries do not satisfy the preconditions for running a sustainable steady-state 3 percent deficit, namely: (i) nominal potential GDP growth of at least 5 percent annually; and (ii) a debt level that is below 60 percent of GDP. But even the EDP is ultimately peer driven: while the Commission has the right of initiative at each stage of the procedure, the ECOFIN Council retains the ability to modify Commission recommendations and so maintains decision-making authority.

III. The Rationale for Fiscal Rules

Fiscal rules in a monetary union can serve a dual purpose—fostering the adoption of time-consistent fiscal policies within countries and improving policy coordination between countries. Drawing a parallel with monetary policy, an effective way to attack the politically-induced deficit bias—a major impediment to medium and longer-term fiscal discipline in many countries—is through a rules-based fiscal framework that constrains the discretion of policymakers and fosters the adoption of credible, time-consistent policies. Moreover, rules can play a crucial role in coordinating fiscal policies across different jurisdictions, especially

Box 1. The Excessive Deficit Procedure

Is there an excessive deficit? A deficit greater than 3 percent of GDP will trigger the EDP as long as the excess is not considered to be exceptional, temporary, and close to the reference value. This criterion is also satisfied if the deficit has declined substantially and continuously and comes close to 3 percent of GDP. A similar caveat for the debt ratio is even looser: in this case, all that needs to happen is for the ratio to be approaching the 60 percent of GDP threshold at a satisfactory pace. When preparing its initial report under the EDP, the Commission takes into account whether the deficit exceeds government investment and also considers "all other relevant factors, including the medium-term economic and budgetary position of the member state".

What are exceptional circumstances? Exceptional is defined as resulting from "an event outside the control of the member state... which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn". In turn, a severe economic downturn is defined as a fall in real GDP by at least 2 percent. A fall between 0.75 and 2 percent may be exceptional, given supporting evidence. A less than 0.75 percent decline is not. The deficit is temporary if it will "fall below the reference value following the end of the unusual event or the severe economic downturn". The SGP does not define the "closeness" criterion. All three must apply for this escape clause to be utilized.

First stage: Within *three months* of the reporting date, the ECOFIN Council decides whether an excessive deficit exists. If so, it will immediately issue a recommendation giving: (a) four months to take "effective action" and; (b) a deadline for the elimination of the excessive deficit, which is typically the year following its identification, barring "special circumstances".

Second stage: After *four months*, if the ECOFIN Council feels that the member state is not implementing the measures, or that they are inadequate, or that data indicate that the excessive deficit will not be corrected within the time limits specified, it will move on to the next step. If the country is deemed to have taken effective action, the procedure is placed in abeyance. Otherwise, within *one month*, the Council will give notice for the member state to take, within a specified time limit, measures to reduce the deficit. This stage is only applicable to countries in the final stage of EMU. The Council may request the member state to submit regular reports to monitor adjustment efforts under enhanced fiscal surveillance.

Final stage: If the member state is in compliance with the notice given, the procedure is held in abeyance. If not, then the ECOFIN Council will move to the sanctions phase within *two months*. By this timetable, sanctions can be imposed within ten months of the reporting date. A non-interest bearing deposit will be required. The first deposit comprises a fixed component of 0.2 percent of GDP and a variable component equal to one tenth of the difference between the deficit and the 3 percent, in percent of GDP. Each following year, the Council may decide to intensify the sanctions by requiring another deposit (variable component only). No single deposit can exceed 0.5 percent of GDP. If the excessive deficit has not been corrected two years after the deposit was made, it shall be converted into a fine. If, before two years are up, the Council considers the excessive deficit to be corrected, it abrogates the procedure and returns the deposit. Fines are not reimbursed. Interest on deposits, and fines, shall be distributed among member states without excessive deficits (proportional to their share in total GDP).

by reducing detrimental spillovers. The architects of EMU were particularly mindful of the supranational dimension.

Under unchecked discretion, the political infrastructure can induce time-inconsistent policies, including a fiscal deficit bias. Optimal fiscal policy is frequently viewed through the prism of intertemporal tax smoothing, with the net present value of spending equal to the net present value of revenues. With this in mind, the budget is maintained in structural balance but deficits can arise from the free play of automatic stabilizers. However, such a policy might not be pursued by policymakers for various reasons related to the political architecture. Alesina and Perotti (1995a) argued convincingly that the differing fiscal outcomes across industrial countries, particularly in the 1970s and 1980s, could not be explained by prevailing economic theories absent any political economy factors. The literature shows that a plethora of inter-related factors—fragmented governments, a high number of spending ministers acting independently, proportional electoral systems, electoral uncertainty, and short government duration—can all act to generate sub-optimal, time-inconsistent fiscal policy (Roubini and Sachs, 1989; Grilli, Masciandaro, and Tabellini, 1991; Alesina and Perotti, 1995b; Kontopoulos and Perotti, 1999; Annett, 2002; Milesi-Ferretti, Perotti, and Rostagno, 2002).

Before the advent of the Maastricht treaty, the effects of unconstrained discretion manifested themselves through various forms of time-inconsistent policies. First and foremost, many countries ran persistent and unsustainable deficits that fed through to rapid public debt accumulation—countries like Belgium, Greece, Ireland, and Italy saw their debt spiraling above 100 percent of GDP during the 1980s or early 1990s with deficits hovering around 10 percent of GDP in many years. Second, most EU countries ran highly procyclical fiscal policies, especially during good times (Jaeger, 2001). This also tended to be more likely under coalition governments (Skilling, 2001) and where political power was dispersed (Lane, 2003). Third, governments in most countries tended to make long-term welfare state promises with scant attention to how they would pay for them, leading to the accumulation of large implicit liabilities. Fourth, electoral considerations affected fiscal policy outcomes across European democracies (Alesina, Roubini, and Cohen 1999).

Spillovers from lax fiscal policy in a monetary union create their own common pool problem, justifying area wide fiscal rules. The ability to pass on at least some of the costs of profligate fiscal policy to other members can exacerbate the common pool problem and heighten the tendency toward time-inconsistent policies in a monetary union. In the euro area, the most commonly raised issues are:

- A country running into fiscal difficulties could be bailed out by other countries or by the ECB purchasing its debt. Although forbidden by the Maastricht treaty, many observers believe that this path would be chosen to stave off a banking system crisis. The likelihood of such a bailout leads to moral hazard problems.

- Price stability could be jeopardized as the ECB faces pressure from profligate countries to lower interest rates and to inflate away the debt. Any announced inflation targets could therefore lack credibility, leading to an inflation bias (Kydland and Prescott, 1977; Barro and Gordon, 1983). This loss of credibility could manifest itself through depreciation of the euro, although policies in counterpart countries clearly also play a role here.

- Expansionary fiscal policy in one country could increase area-wide interest rates. Domestic policymakers fail to take into account the impact of domestic fiscal policy on other countries in the area. The link between domestic fiscal policy and interest rates is loosened.

IV. Does the SGP Meet the Criteria of a Good Fiscal Rule?

The SGP must be judged along two parallel dimensions: First, does it foster the adoption of time-consistent policies, remedying deficit biases? Second, is there a benefit in having a supranational rule at all? The answer to both questions appears to be a qualified "yes", despite various enforcement difficulties.

As a rules-based framework, the SGP is well suited to addressing the deficit bias in fiscal policy. As with monetary policy, time-consistent policies can be attained by binding the hands of policymakers, by eschewing unconstrained discretion, and by adopting a rules-based framework. In many ways, the framework for coordinating fiscal policies of EU countries displays the characteristics of a model fiscal rule and is generally appropriate in the context of the monetary union (Kopits and Symansky, 1998). It is well-designed, insofar as it is *simple, clearly defined*, and *transparent*, especially with respect to those parts that relate to gross policy mistakes. Of course, there will be a fundamental trade-off between the credibility of the rule and *flexibility*. But the SGP does embody a fair degree of flexibility, not least given that the CBS rule is designed in a way that lets automatic stabilizers work. Also, the definition of gross policy mistakes (deficits exceeding 3 percent of GDP) is *adequate with respect to the goal* of maintaining stability in the monetary union. Absent policies to remedy the fiscal pressures related to aging, monetary policy could face major difficulties over the longer run. Furthermore, persistent breaches of the 3 percent limit might destabilize the union over the medium run. Moreover, the SGP serves as a useful external commitment technology, which is especially valuable in countries with histories of macroeconomic or fiscal volatility, or politically-induced deficit biases; and it helps countries focus on medium- to long-term issues.[1]

However, observers have raised questions over whether the framework is sufficiently *flexible* and *enforceable* and whether it allows for sufficient *ownership*. Critics have charged that the EDP is too blunt and mechanical. Also, the preventive arm is seen as failing to take country-specific sustainability factors into account sufficiently, calling as it does for CBS in all countries regardless of circumstances. Mostly, however, this criticism fails to give due weight to the need for any rule to be simple and transparent, particularly if it is supranational (Schuknecht, 2004). Others have drawn attention to deficiencies in the enforcement mechanism as the principal chink in the SGP's armor (Buti, Eijffinger, and Franco, 2003). Inman (1996) argues that while the EU fiscal framework is effective, it trips up on enforcement which is partisan rather than independent, resulting from its peer-driven nature. Enforcement problems tend to be related to ownership, as many have argued that the SGP is too "top-heavy" and not sufficiently respectful of subsidiarity.

V. How has the SGP fared in practice?

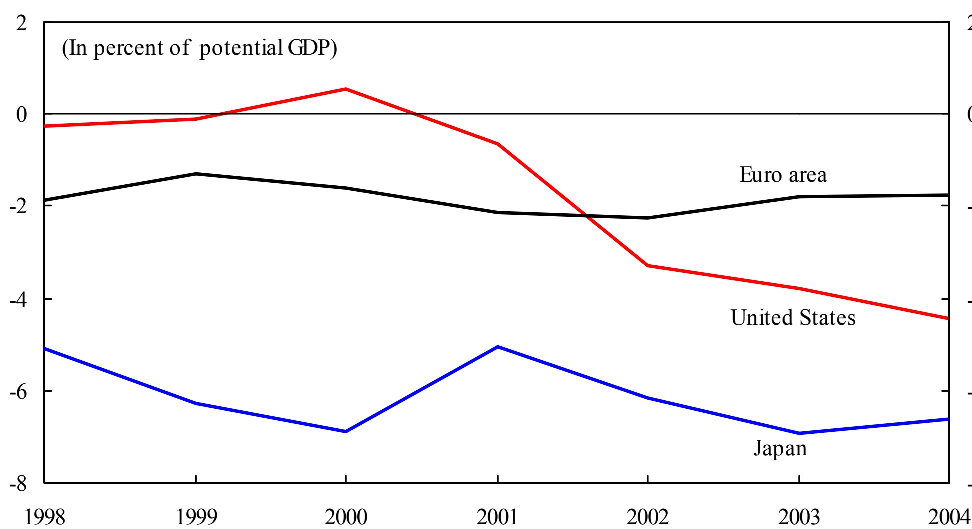
The SGP's record to date has been mixed. On the whole, the framework contributed to greater fiscal discipline across the union. But at the same time, improvements have fallen

[1] Some have argued that this has even provided governments with useful external pressure to reform pension systems (Beetsma, 2001).

short of requirements, as the CBS target in particular remained out of reach for many countries. Moreover, some countries became entangled in protracted legal procedures related to the Pact's implementation. Enforcement and ownership have proven to be the key problems.

The SGP has been conducive to fiscal discipline, reducing past biases toward fiscal deficits. By the onset of EMU in 1999, all of the present euro-area member countries (bar Greece) had succeeded in bringing their deficits under 3 percent of GDP—for some, this had called for substantial adjustment. The average euro-area deficit over the period 1999-03 stood at 1½ percent of GDP, a full 3 percentage points below the earlier post-Maastricht era (1992-98) average. The area's disciplined fiscal performance over the last five years stands in sharp contrast with other major currency areas (Figure 1). Fiscal policy also seems to have become less procyclical under Maastricht (Gali and Perotti, 2003) or the SGP, especially after the emphasis shifted from nominal to structural balances (Fatas and others, 2003).

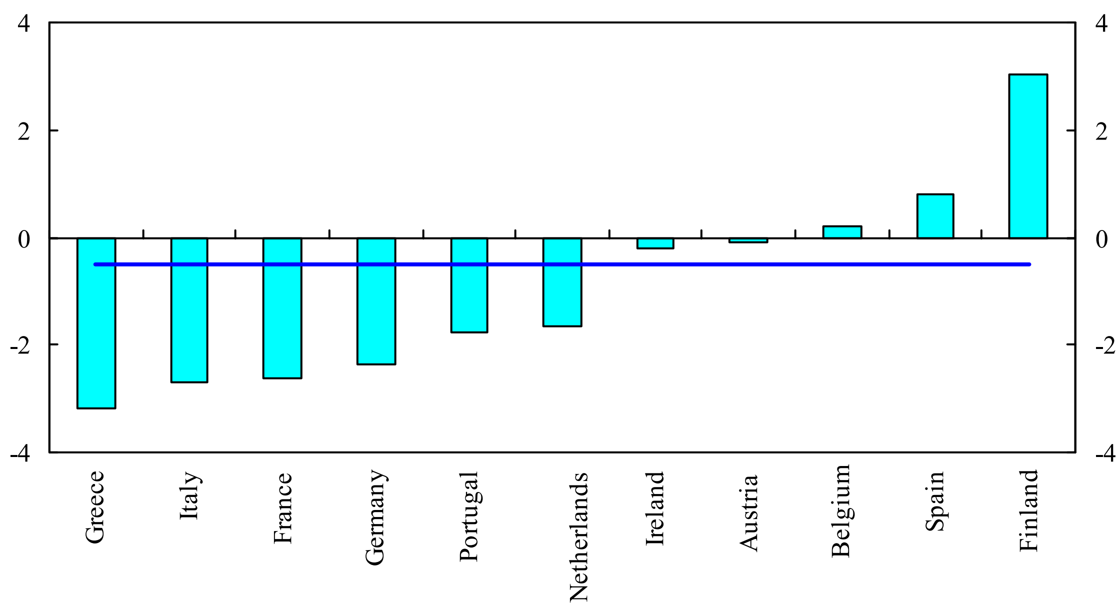
Figure 1. Structural Balance in the Euro Area, United States, and Japan, 1998-2004



Source: IMF, World Economic Outlook.

But legacies from past time-inconsistent policies continue to haunt the area. For numerous countries, including the largest members, procyclical fiscal leakage during good times remained alive and well under the SGP. These countries failed to take advantage of propitious circumstances to push for underlying balance during the upturn, and some allowed their underlying positions to slip further during the downturn. The CBS criterion thus proved elusive for many countries (Figure 2). Meanwhile, the high-debt countries—Greece and Italy in particular—made scant progress in reducing their debt ratios. Also, few countries made much headway in tackling the large stock of looming implicit liabilities: risks to long-term sustainability are evident in 8 of the 12 countries (European Commission, 2004). More immediately, a number of countries have engaged in serial breaches of the 3 percent ceiling, and the list of deviant countries is growing.

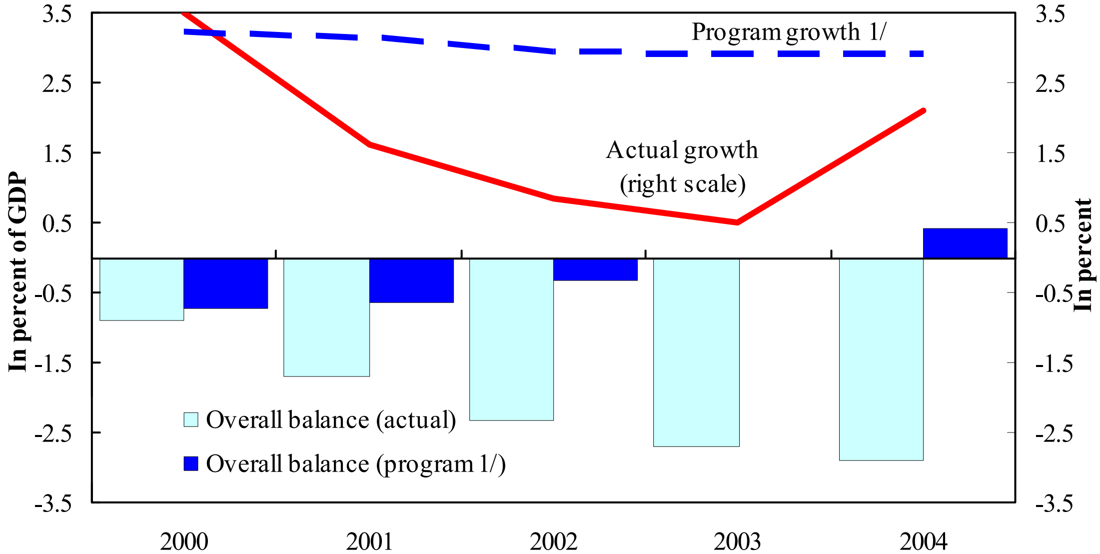
Figure 2. Structural Balance in Euro Area Countries, 2004
(In percent of potential GDP)



Source: IMF, World Economic Outlook.

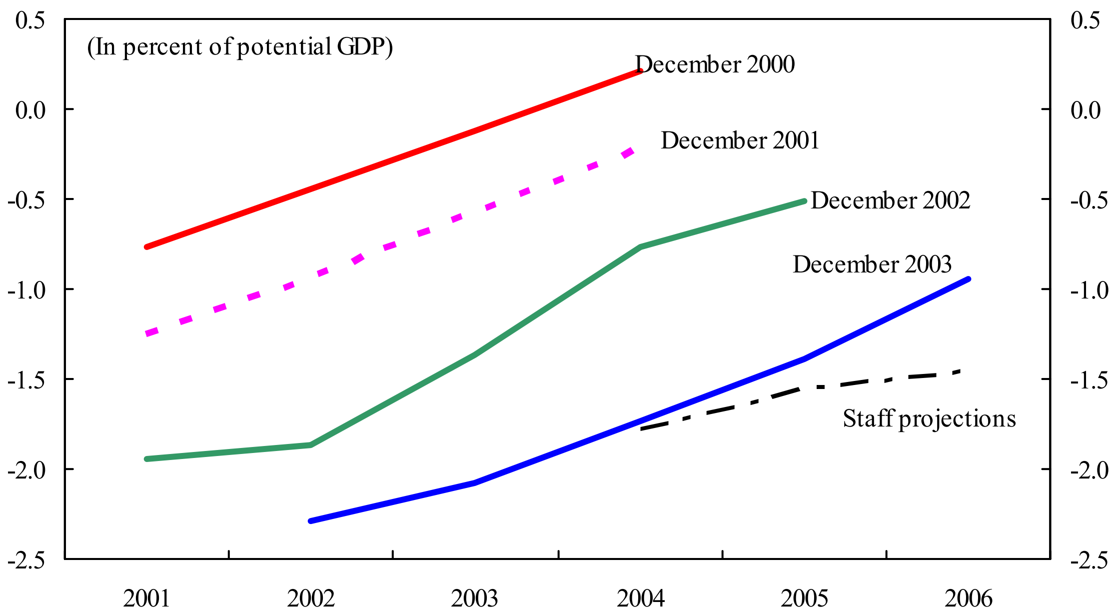
Time inconsistency under the SGP comes in numerous guises. The framework itself leaves in place incentives toward time-inconsistent policies with a short-term bent. The following examples bear this out:

Figure 3. Euro Area: Real Output Growth and Fiscal Balance, 2000-2004



Sources: European Commission; and IMF, World Economic Outlook.
1/ December 2000 Stability Programs.

Figure 4. Euro Area: Shifting Structural Balance Targets in Stability Programs, 2001-2006



Source: European Commission.

- *Overly-optimistic assumptions:* Adjustment fell far short of what was promised in Stability Programs. Numerous countries relied on overly-optimistic growth assumptions, reducing the pressure to plan substantial medium-term adjustment (Annett, 2004; Jonung and Larch, 2004; Strauch, Hallerberg, and von Hagen, 2004). This strategy enabled governments to show favorable programs, while allowing them to blame poor outcomes on the economy (see Figure 3). In essence, persistently over-optimistic estimates of potential growth led to growth disappointments and repeated downward revisions of structural balance targets in each Stability Program vintage, with each successive revision pushing the CBS target farther out on the horizon (Figure 4). Had the projected growth materialized, the adjustment trajectory would still have been unambitious for good times. Indeed, history may well repeat itself as the 2005 budgets show little ambition.

- *One-offs, creative accounting, and misreporting:* The emphasis on numerical values, particularly the enshrined 3 percent deficit limit, creates incentives to circumvent the rule without actually undertaking the requisite adjustment. The tendency toward one-off measures is spreading, as countries focus on getting below, or staying below, the 3 percent limit. Many also argue that countries under the SGP relied heavily on stock-flow adjustments that added to debt but had no effect on the deficit (von Hagen and Wolff, 2004). In this regard, an oft-exploited issue with the accounting framework is that the deficit measure excludes financial transactions. In some cases, such transactions can be questionable, such as when a financial transaction is a disguised capital injection. Moreover, in some countries there are wide gaps between the accruals deficit, the cash deficit, and the annual change in debt; oftentimes the discrepancies are not transparent (Balassone, Franco, and Zotteri, 2004). In the most serious case, misreporting of data in Greece showed a lower deficit than actually existed, on the order of about 2 percentage points a year.

- *Electoral effects:* Electoral cycles under EMU may have contributed to a deficit bias in numerous countries. The electoral calendar was quite full in the early years of EMU. Governments tended to cut taxes and increase spending as elections approached; this effect was more pronounced in the upswing (Buti and van den Noord, 2004). The inability of the SGP to foster adjustment during recoveries has a lot to do with political budget cycles, as might be borne out again at the current juncture.

At the same time, the procedural aspects of the Pact ran into some major hurdles. On the preventive side, peer pressure and multilateral surveillance did not always work well, while the application of the EDP was fraught with difficulty:

- *The EDP did not distinguish adequately between policies and economic circumstances*. To date, the application of the EDP has tended to be overly mechanical, with its momentum based on the likelihood of the excessive deficit being eliminated in the given time period, irrespective of whether or not the country has adopted the required corrective measures. This lack of flexibility was a contributory factor to a procedural impasse that arose during the application of the EDP, which needed a ruling from the European Court of Justice to resolve.

- *Early warnings proved ineffective*. ECOFIN refrained from issuing early warnings to countries that subsequently breached the 3 percent limit. Other warnings failed to forestall an excessive deficit. Moreover, early warnings have been restricted in scope, failing to address ill-conceived fiscal policy in good times and dealing only with the potential to exceed 3 percent in the near term.

Looking back over the past five years, the SGP tripped up on issues of enforceability and ownership, while inadequate flexibility played a secondary role. Enforcement was a problem for both arms, given the failure to attain CBS by many countries and serial breaches of the 3 percent limit by some. A pessimistic appraisal would say that large countries in particular would never allow themselves to be subject to the full rigors of the EDP. But the rigid implementation of the EDP also presented a problem. The preventive arm suffered from insufficient ownership. However, insufficient country specificity, including a lack of attention to sustainability in setting medium-term targets, was not a significant factor.

VI. Reforming the SGP

A. Introduction

Reforms should focus on the key chinks in the SGP's armor—enforcement and ownership—primarily by promoting transparency and domestic accountability, while strengthening the economic underpinnings of the rules without undermining time consistency. Specifically, there is no compelling case for reformulating the CBS criterion or redesigning the EDP, except with respect to the adjustment horizon. Improving enforcement and ownership at the preventive stage calls for complementing the roles of the Commission and Eurostat in budgetary surveillance through more emphasis on domestic governance institutions, especially independent fiscal councils with a strong vetting role. In addition, the profile of Stability Programs in national political debates needs to be raised. The following sections tackle these issues in some detail.

B. Fostering Enforcement and Ownership: The Role of National Institutions

Any reform proposals must improve transparency and enhance domestic accountability, to strengthen the incentives to adopt time-consistent policies. From a governance perspective, the problems with the current implementation of the Pact are evident. A lack of transparency—manifesting in numerous guises including one-off measures, creative accounting, and misreporting—has become an increasing problem. Medium-term plans laid down by the Stability Programs continue to be plagued by unrealistic assumptions and constant revisions. Greater domestic ownership could combat these tendencies toward non-transparent and time-inconsistent policies. An oft-overlooked aspect of the Maastricht treaty is the call for member states "to ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from the Treaty". In this light, reforms should shift a higher burden of surveillance and enforcement onto individual countries.

Governance reforms should focus on complementing the oversight bodies of the center—the Commission and Eurostat—by establishing national budgetary institutions aimed at securing independent assessments of fiscal policies that are subject to parliamentary oversight. Such reforms, while of great consequence to the SGP, would constitute important steps towards improved governance irrespective of the fiscal framework. In particular:

- *Independent fiscal councils*. National watchdog bodies would monitor compliance with the Stability Programs and appraise fiscal policy under the SGP framework. If credible, highlighting any deviation from the Stability Program path could lead to reputational costs for the government. These bodies could also ward off non-transparent tendencies which often culminate in creative accounting and even misreporting. Ideally, these institutions would prepare the macroeconomic framework underlying the budget and Stability Program, as well as baseline fiscal projections and estimates of yields from policy measures announced by the government. They would also be expected to assess the likely yield from measures under the EDP. Independent forecasts are critical in the elimination of politically-motivated forecast biases (Jonung and Larch, 2004), and the independent fiscal council is the natural entity to generate these forecasts. Some EU countries do indeed delegate the task of generating official projections or assessing fiscal policy to independent agencies.[2]

[2] The Central Planning Bureau in the Netherlands, for example, is mandated with producing independent economic forecasts and monitoring the state of public finances. In Belgium, the (continued)

- *Parliamentary oversight*. The independent councils would report to parliaments, which would assume a greater oversight role over the country's compliance with the SGP. Reports by these councils, as well as the Stability Programs themselves, should be subject to parliamentary debate together with the national budgets. In line with Commission proposals, the Stability Programs should be integrated into the national budget cycle and their presentation advanced to early summer. This would greatly enhance the authority of national Stability Programs, with beneficial effects for enforcement and ownership.

- *The role of the center*. Commission assessment of fiscal policy, as mandated by the Treaty, should remain a vital component of EU governance. At least until such time as the independent fiscal councils are well established, countries should use Commission forecasts in setting budgetary policy. Additionally, Eurostat should be granted more power to vet national data.

Problems relating to national statistics cannot be tackled by Eurostat or the fiscal councils alone but require fundamental governance reforms. In particular, to act as a bulwark against misreporting, national statistical agencies should be endowed with sufficient independence to be free from political pressures. In the meantime, the Commission should certainly make use of a greater range of fiscal indicators—such as the cash deficit and the change in the debt—when monitoring fiscal developments in a country, given evidence that revisions to these indicators are less common than to the ESA95 deficit (Balassone, Franco, and Zotteri, 2004). Relying on multiple estimates also makes it harder for countries to rely on stock-flow adjustments and creative accounting to meet particular targets.

C. Strengthening the Economic Underpinnings of the EDP

The procedural impasse with respect to the application of the EDP against key countries has prompted calls for a more economically rational dissuasive arm of the SGP. In this regard, various proposals have been put forth, including: (i) allowing for more country-specific elements in setting the adjustment path; (ii) relaxing the "exceptional circumstances" escape

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Federal Planning Bureau provides forecasts, while the High Council of Finance recommends fiscal targets and assesses policy. See Jonung and Larch (2004) and Hallerberg (2004).

clause;[3] or (iii) bringing “other relevant factors” to the fore in deciding whether an excessive deficit prevails (see Box 1). The advantage of the first proposal is that it launches the EDP and places countries under its surveillance procedures. It would foster a more transparent and open discussion of the fiscal difficulties facing a country, a key prerequisite in establishing ownership of the required adjustment. It is also consistent with the strategy adopted for the new member states under the EDP. The case for altering the “exceptional circumstances” clause is less clear cut, and would in any event rarely bite. Furthermore, bringing “other relevant factors” to the fore risks seriously undermining the transparency and credibility of the Pact.

Under the EDP, a country’s adjustment path should stress the adoption of corrective measures rather than deadlines for fiscal outcomes. The initial recommendation to a country would set out a deficit reduction path—based on the agreed timeframe for eliminating the excessive deficit—anchored on specific policy measures to be taken each year. Special circumstances, justifying an extended period to eliminate the excessive deficit, should be clearly defined. Absent special circumstances, the excessive deficit should be eliminated in the following year. A new deadline for the elimination of the excessive deficit within the procedure could be granted, if outcomes are worse than expected (owing, for example, to a shortfall in economic growth from projections) but the agreed-upon measures have been adopted. Instead of remaining outcome based, compliance with effective action would be assessed based on whether the country has undertaken the agreed-upon fiscal effort. To enable countries to adopt high-quality measures, consideration could also be given to extending the deadlines for undertaking effective action at each stage in the procedure. The procedure would remain open until the excessive deficit is eliminated, with the option of ratcheting it up upon signs of policy slippage (effective action not taken). In a nutshell, the idea is to better distinguish between “bad policies” and “bad luck” in the EDP.

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[3] One proposal under discussion is to replace the -2 percent cut-off with negative growth, and also to consider the abruptness of the downturn.

The conditions for allowing an extended timeframe for eliminating the excessive deficit should be narrow and precise. Discretion concerning the length of the adjustment period should be minimized:

- Ex ante extensions could be given if economic circumstances suggest that elimination of the excessive deficit within a year would be unreasonable given the presumption that measures amounting to at least ½ percent of GDP a year have or will be taken. Ex post extensions could be granted within the procedure if fiscal outcomes turn out to be weaker than expected, such as from lower growth, and countries submit evidence of actual adjustment (of having taken measures that delivered the agreed-upon amount of underlying adjustment).

- The need to be transparent (and therefore simple) and to foster time-consistent policies is especially pertinent at the dissuasive stage. It would therefore be unwise to try to give credit for structural reforms in the application of the EDP. But an exception could be granted for a country which breaches the 3 percent solely on account of establishing a multi-pillar pension system; this is consistent with the advice given under the CBS rule provided it is strictly limited in scope (see Section D).

- There is also little justification for conditioning the timeframe on debt levels, one option proposed by the Commission. To foster time-consistent policies, however, credit could be given under the EDP if countries reduce their debt ratios by a certain cumulative amount during the preceding years (see below).

In light of the proposals for altering the deadline in the midst of the procedure, the reformed EDP will need to guard against the use of overly-optimistic projections. An overly-optimistic growth projection could lead to an extension to the deadline once the process has been opened and growth disappoints. Moreover, if the emphasis is to shift from outcomes to measures, there will be an incentive to produce overly-optimistic yields from various measures. To guard against these time-inconsistent tendencies, governments should rely on projections from independent national fiscal councils, or, in their absence, on Commission forecasts. Moreover, countries under the EDP should also be required to rely on fiscal councils for the preparation of the macroeconomic framework, the "unchanged policies" projections for revenue and expenditure, and the estimates of how much the measures yield in their programs. Especially in the absence of such councils, Commission assessments of macroeconomic and budgetary prospects and of the effectiveness of measures should be given primacy.

Proposals to enhance the surveillance over debt are welcome, notably those to operationalize the debt criterion in the EDP. This aspect of the Maastricht treaty has been effectively ignored: some countries increased their debt, while others made little headway with reducing it, including those with debt ratios well above 60 percent. More attention to debt reduction for sustainability purposes is warranted by the slower potential growth combined with lower inflation than anticipated by the framers of the Treaty. Moreover, the tendency to resort to debt-enhancing financial transactions to meet deficit targets—increasingly prevalent under the SGP—calls for a second numerical target to close off this loophole and encourage countries to focus on true adjustment. In the context of the EDP, however, it will be particularly important to have a simple and transparent criterion.

Lastly, countries need stronger incentives to adjust during the upturn to avoid falling into the EDP. The ability of the Commission to issue early warnings directly—as envisioned by the new Constitution—could help, but this should not be overplayed. Early warnings should focus principally on ensuring sound fiscal policy during good times, but should not be the only ammunition in the Pact's arsenal geared toward enforcing the preventive arm. The role of domestic governance institutions remains paramount in this regard. But lenient treatment under the EDP—in the form of a longer timeframe to eliminate the excessive deficit—could also be allowed for countries that adjust during good times, measured by the cumulative reduction in the debt ratio over the past (say) three years.[4] Such countries might be permitted an extra year to eliminate the excessive deficit, which would be the reward for good behavior. One-off measures or stock-flow adjustments would not count.

[4] Running surpluses during upswing periods should permit annual debt-to-GDP ratio reductions of about 5 percent. A country could, for example, be granted additional time to adjust under the EDP if in the preceding, say, three upswing years its debt-ratio has fallen by at least one tenth.

D. Sound Medium-Term Fiscal Policy Rules

A key aspect of the reform proposals under discussion involves improving the economic underpinnings of the SGP by tying the CBS criterion to country-specific sustainability factors (European Commission, 2004). While focusing mainly on initial debt levels, the possibility of taking account of other factors—including potential growth rates, implicit liabilities, and structural reforms—is also raised. Reform along these lines offers a number of advantages. First, flexibility is a feature of a well-designed fiscal rule and many commentators argue that the CBS needs better economic underpinnings. Second, moving more toward country-specific factors could offer greater legitimacy and country ownership, thus increasing the credibility of the SGP and improving enforcement. However, in many ways the current CBS criterion offers enough flexibility.

Any re-definition of the CBS rule should be measured along the following yardsticks:

- *The CBS rule should remain relatively simple and transparent, lest it give rise to endless manipulations*. The informational requirements in implementing a rule based on sustainability considerations are vast, relying on estimates of long-term macroeconomic and budgetary parameters (Box 2 discusses the manifold difficulties in operationalizing a sustainability rule). Even the present, arguably limited, requirements have not been met by all countries. It is difficult to see how the framework could remain reasonably simple and credible while trying to incorporate a broad array of sustainability-related factors, including structural reforms. Hence it should stick to a simple formulation involving clearly quantifiable variables. In many ways, the CBS condition as currently defined (if not as interpreted) offers a fair degree of flexibility, and could conceivably take both cyclical sensitivity and sustainability factors into account.

- *The CBS rule should not morph into a series of individual country rules*. On the enforcement side, excessive loosening of the Pact's precepts to take account of country-specific factors could cause the external anchor to become undone in the countries that need it most. In the extreme case, the push for "country circumstances" would lead to country-specific sustainability-based fiscal rules with the Commission acting as mere referee—in effect, N rules for N countries.

- *The overall ambition of fiscal policy should not diminish.* In particular, the choice of the medium-term underlying balance should not place the countries at risk of breaching the 3 percent criterion in a downturn. This constraint clearly limits the degree of cross-country dispersion allowed in setting the CBS rule. But a low dispersion may lead to targets insufficiently different from the current ones to justify the additional operational complexity. Also, it is important to avoid a loosening of fiscal policy in some countries without a symmetric tightening in others. While a symmetric approach might by resisted by the countries facing tougher standards, an asymmetric approach could lead to concerns about evenhandedness. The reform needs to balance these competing considerations.

The proposals that are under discussion could be difficult to operationalize without opening a Pandora's box. As noted, a true sustainability rule would face monumental implementation difficulties, implying that a realistic rule incorporating sustainability factors needs some element of compromise. Clearly, any such formula will be highly mechanical and any targets will depend heavily on the chosen methodology, which will be uncomfortably ad hoc; this could easily give rise to new criticism and calls for reform when politically expedient. Table 1 shows the medium-term targets that would emerge from some of the proposed approaches—a simple debt rule based on European Commission (2004) and an approach based on the partial elimination of implicit liabilities from the French authorities. In many cases, the targets do not differ substantially from those emerging from the current methodology. An attempt to induce greater dispersion based solely on debt levels could lead to inappropriate fiscal laxity, especially if looser targets in some countries are not matched by

Table 1: Country-Specific Medium-Term Deficit Targets

	Initial debt (2003)	EC-Low Incentive 1/	EC-High Incentive 2/	France DOB 3/
Austria	64.9	-0.5	-0.3	-0.7
Belgium	103.0	-0.1	1.2	0.5
Finland	45.5	-0.6	-1.1	-0.6
France	63.7	-0.5	-0.4	-1.0
Germany	63.8	-0.5	-0.3	-0.2
Greece	103.0	-0.1	1.2	0.7
Ireland	33.2	-0.8	-1.6	-2.9
Italy	106.2	0.0	1.3	-0.4
Luxembourg	4.9	-1.1	-2.7	...
Netherlands	55.0	-0.6	-0.7	0.1
Portugal	60.3	-0.5	-0.5	-1.5
Spain	50.7	-0.6	-0.9	-1.1
Denmark	43.3	-0.7	-1.2	-0.7
Sweden	51.9	-0.6	-0.8	-1.2
United Kingdom	39.6	-0.7	-1.3	-2.5

1/ Medium-term deficit target: d=0.5+0.1(b--0.6), where b is initial debt.
2/ Medium-term deficit target: d=0.5+0.4(b--0.6), where b is initial debt.
3/ Reaching 60 percent of GDP debt in 20 years and eliminating one third of unfunded liabilities.

Source: European Commission (2004), France DOB (2004), and staff estimates.

tighter requirements for others. Furthermore, making allowance for potential growth rates could also be unwise. This would lead to more lax targets for the new members, precisely those countries that are prone to higher macroeconomic volatility.

The CBS rule should not take account of implicit liabilities or structural reforms. To address sustainability properly, the SGP would need to treat implicit debt in the same manner as explicit debt. But this creates untoward operational difficulties, given the manifold uncertainties involved (Box 2). That said, the measurement of implicit liabilities has been studied in much more depth than that of the fiscal payoff to structural reforms. Several member countries propose taking structural reforms into account—through either a deviation from the medium-term target, or through delayed adjustment toward this target—to trade off short-term budgetary costs against long-term growth benefits. But the benefits of these reforms—including tax cuts, increased expenditure on education and R&D, and investment projects—are highly uncertain as regards both magnitude and timing. Trade-offs between structural reforms and fiscal targets could therefore put the credibility of the framework on the line, opening the door to time-inconsistent policies (such as pension cutbacks that are later abandoned or offset with other measures) and endless manipulations (such as overly-optimistic assumptions concerning the projected benefits of structural reforms). Therefore, the case for taking account of structural reforms in the SGP is even weaker than for implicit liabilities.

But a special case could be made for the treatment of second pillar pension reforms. When it comes to the choice of pension reform, the SGP should endeavor to guarantee a level playing field and allow countries to choose from an array of options—including pay-as-you-go parametric reforms, developing private pillars, prefunding, or boosting labor utilization—based on national preferences. Establishing a second pillar pension scheme can run into problems with the SGP over treatment of the transitional costs. A recent Eurostat decision, mandating the exclusion of second pillar schemes from the government sector on the grounds that the effective risk is borne by private agents, makes it harder for countries adopting such reforms to meet SGP targets. To tackle this, temporary (for example, covering the standard horizon of a Stability Program) allowance under the SGP could be granted to countries which

Box 2. A Fiscal Sustainability Rule?

A fiscal plan is sustainable if it ensures government solvency. For solvency, the level of net debt needs to be no larger than the present value of all future primary surpluses (all as a percent of GDP), discounted by the real interest rate minus the real growth rate. In this context, the permanent primary surplus is defined as a constant level of the primary surplus whose present discounted value is equal to the present discounted value of actual or anticipated primary surpluses. The government's intertemporal budget constraint or solvency condition can be simplified: the debt-GDP ratio can be no greater than the permanent primary surplus divided by permanent (long-run) differential between the real interest and real growth rate.

A fiscal rule focusing on sustainability would have an intertemporal approach as in the "permanent balance rule" (PBR) of Buiter and Grafe (2003). This rule seeks a constant tax rate which is at least equal to the sum of the permanent expenditure share plus the long-run growth-adjusted real interest cost of government debt minus permanent government capital income. Such an approach, consists of a positive and a normative pillar: the positive aspect focuses on solvency, while the normative factor promotes tax-smoothing ($t=t^p$) as the answer to sustainability. The PBR gives rise to the following condition for the deficit, d (where g is total government expenditure, k is the public capital stock, θ is the gross financial return on the government capital stock, r is the real interest rate, n is the real growth rate, b is the stock of debt, and the superscript p represents the permanent value):

$$d \leq \left[g - g^p\right] + \left[\theta^p k^p - \theta k\right] + \left[\left(r - r^p\right) - \left(n - n^p\right)\right]\mathrm{b}$$

Sustainability, therefore, depends on four country-specific factors: initial net debt, the permanent primary surplus (incorporating such factors as public investment needs and implicit liabilities), long-run growth, and the long-run real interest rate. Fundamentally, a rule focused on sustainability would force a country to deal with the costs of aging today. Also, the borrowing restriction is loosened when interest rates or expenditure are temporarily high, or when the real growth rate is temporarily low (following the adoption of structural reforms, for example). In contrast, the SGP only takes into account one of these four factors, and even that focuses on gross rather than net debt.

However, the costs of making a "sustainability rule" operational are formidable. It would be necessary to derive estimates of long-term growth rates and interest rates and to lay out the path of future permanent expenditure plans for each country. A true picture of future expenditure would also need to take account of both contingent and implicit liabilities. Contingent liabilities are by definition uncertain, based on the underlying risk facing the government, and could become even more pronounced in the future (through, for example, the use of Public-Private Partnerships). Implicit liabilities consist of obligations without legal basis, grounded in expectations which can shift over time as new governments attempt to re-frame the debate. Adding to the complexity, liabilities can be both contingent and implicit, as would be the case should the government be expected to bail out a private pension fund. Lastly, the normative pillar is not uncontroversial, raising issues concerning the optimal size of government and the incentive effects of high tax rates on growth and employment—issues clouded by much uncertainty (see Disney, 2000). Mechanically implementing a rule such as the PBR would therefore not be viable.

undertake this reform, as long as it balances the upfront costs with unambiguous long-term budgetary benefits.

All in all, the case for redefining the CBS criterion (or rewriting the underlying regulation) is not compelling. The proposed new approaches tend to give rise to targets that are not incompatible with the legal text relating to the CBS criterion. Achieving a differentiation that accommodates sustainability concerns does not warrant the operational complexity, and the concomitant loss of simplicity and transparency, of embarking on the proposed major reform. Crucially, the CBS rule should not make allowance for structural reforms, as this could lead to time-inconsistent policies—precisely what the SGP strives to avoid. A very narrow exception to this principle could be made for second pillar pension reforms.

VII. Conclusion

The current fiscal travails have their origins in the fiscal profligacy during good times, and the failure to get to grips with Europe's diminishing growth potential. Addressing the long-run dimension of this fundamental problem will require comprehensive structural reform. Stronger fiscal policies are an essential element of such a reform strategy and the SGP should play a central role. To that effect the fiscal framework should remain focused on the goal of eliminating politically-motivated deficit biases and other aspects of time-inconsistent fiscal policy. Theory provides a strong rationale for a fiscal framework such as the SGP, which boasts many of the characteristics of a model fiscal rule and serves as a useful external anchor, particularly for the smaller, more open, economies. But the legacy of time-inconsistent policies lingers—many countries are far from underlying balance, do not take the fiscal plans underpinning Stability Programs seriously enough, keep seeking new ways to meet numerical targets without undertaking real adjustment, and are increasingly likely to become entangled in the EDP. Clearly, reforms are needed. But reforms should be sure to tackle the underlying deficiencies in the Pact—namely inadequate enforcement, ownership, and, to a lesser extent, flexibility—without diluting its time-consistent elements. We would focus on the following issues:

- Strengthening the economic underpinnings of the EDP, through a stronger focus on measures instead of outcomes.

- Taking into account pension reforms that introduce a second pillar but not other structural reforms with uncertain benefits in assessing fiscal performance.

- Folding national Stability Programs into national budget cycles, including parliamentary debates, to enhance their authority.

- Enhancing transparency and domestic accountability through the creation of independent fiscal councils, reporting to parliaments, that vet budgetary policy under both the preventive and dissuasive arms of the SGP. This would increase the reputational cost associated with a deviation from stated plans, and also guard against overly-optimistic assumptions, lack of transparency, misreporting, and other manipulations. In the absence of such councils, the European Commission and Eurostat should be given greater weight in vetting projections, assumptions, and budgetary data.

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