Reforming the Stability and Growth Pact: Breaking the Ice

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Abstract

This paper presents a critical assessment of the Stability and Growth Pact (SGP). Section 2 recalls the fiscal policy framework in the euro area. Section 3 provides an assessment of the first five years of the SGP. Section 4 addresses the weaknesses of the procedures: arbitrary criteria, insufficient economic policy co-ordination. Section 5 discusses European Commission's recent proposals: strengthening its influence on national fiscal policies; considering 'close-to-balance or in surplus' underlying budgetary positions. Section 6 discusses recent academic proposals: budgetary federalism, golden rule, permanent balance rule, public expenditure rule, fiscal policy committees, public debt surveillance... In section 7 we suggest that national budgetary policies should be responsible for managing the inflation-production trade-off, under a medium term inflation objective, while monetary policy would target interest rates. This policy mix would give better outcomes in terms of economic stabilisation than the existing framework.

Keywords: Stability and Growth Pact, EMU, fiscal policy, monetary policy, public debt

JEL classification: E6

Résumé

Ce texte présente une évaluation critique du Pacte de stabilité. La première partie rappelle les modalités actuelles du contrôle des politiques budgétaires dans la zone euro : la limite des déficits publics à 3 % du PIB, les programmes de stabilité, les Grandes orientations des politiques économiques. La deuxième partie présente une évaluation des cinq premières années d'existence du Pacte. La troisième partie analyse les défauts de l'organisation actuelle : l'arbitraire des critères de finances publiques et l'absence d'une réelle coordination des politiques économiques. Une quatrième partie discute des propositions récentes de la Commission : renforcement de son influence sur les politiques budgétaires nationales, prise en compte de soldes structurels proches de l'équilibre ou excédentaires. La cinquième partie discute des propositions récentes des économistes : fédéralisme budgétaire, règle d'or des finances publiques, règle d'équilibre permanent, règle de dépenses publiques, comité de politique budgétaire, contrôle des dettes publiques. Dans une sixième partie nous proposons que les politiques budgétaires nationales aient la charge de gérer l'arbitrage entre inflation et production, sous une contrainte d'inflation de moyen terme, tandis que la politique monétaire aurait un objectif de taux d'intérêt.

> 'I know very well that the Stability Pact is stupid, like all decisions that are rigid', Romano Prodi, *Le Monde*, 18 October 2002.

1. Introduction

Since the early days of the Stability and Growth Pact (SGP), the provisions inherited from the Maastricht Treaty have been criticised by a number of economists and policy makers arguing that the procedures of fiscal surveillance were not providing a satisfactory framework of economic policy co-ordination in the European Union. The implementation of the SGP started in a favourable situation of high growth. Problems started to show with the economic slowdown of late 2000. The need for reforming the SGP became more and more obvious in the course of 2002. A number of economists have made different and sometimes contradictory proposals. The European Commission itself has made proposals. This paper presents the state of the debate.

Section 2 recalls the fiscal policy framework in the euro area. Section 3 provides an assessment of the first five years of existence of the SGP, up to the latest economic developments. The weaknesses of the existing framework are addressed in Section 4. Section 5 discusses the reforms recently proposed by the Commission. Section 6 discusses some of the proposals recently made by economists to improve the fiscal policy framework. We present our proposal in section 7.

2. The existing fiscal policy framework

Before the launch of the economic and monetary union (EMU), two views had been opposed on the conduct of fiscal policies. In one view, the EMU should allow each Member State to choose and run domestic fiscal policy in full independence. Independent fiscal policy is a prerequisite to domestic macroeconomic stabilisation in a monetary union since monetary policy can be conducted at the area aggregate level only and becomes ineffective in the event of asymmetric shocks. The exchange rate can no more be used as an instrument of economic policy. Price and wage adjustments, as well as labour mobility, play a minor role only in Europe. But fiscal policy becomes more powerful in a monetary union as it will not be counteracted by interest rates rises or exchange rate depreciation. Let us assume, as in table 1, that six Member States are hit by a depressive shock while 3 are hit by an expansionary one. Monetary policy, which considers the average situation in the Union, can be at best slightly expansionary. In this case there is a need for different fiscal polices in order to stabilise fully national economies.

According to another view, if each country was allowed to conduct fiscal policy without any binding rule, there would be a risk that all countries run excessively expansionary policies for three reasons. First, countries in a monetary union do not have to care anymore about their current account balance. Second, they are no more under the threat of speculation on domestic exchange rate and interest rate markets. Last, a country implementing an expansionary fiscal policy alone will not be strongly affected by the central bank's reaction. This is illustrated in table 2. Country 12 implements a strongly expansionary policy. The subsequent tightening of monetary policy affects all countries. In the end, country 12 benefits from a gain in output, at the expense of the rest of the area.

Table 1. Optimal policies in response to a shock in EMU

	Initial shock	Monetary policy	Fiscal policies
Countries 1-6	– 4	+ 1	+ 3
Countries 7-9	0	+ 1	– 1
Countries 10-12	4	+ 1	– 5
Average	– 1	+ 1	+ 0

Table 2. Free rider's policy in EMU

	Fiscal policies	Monetary policy	Result
Countries 1-11	0	– 1	– 1
Country 12	12	– 1	11
Average	1	– 1	0

The single currency strengthens the level of interdependence between participating countries through two new channels. First, each country becomes potentially affected by inflation in partner countries as it will lead to a rise in the European central bank's (ECB) single interest rate. Second, a country unable to ensure sustainable public finances would put at risk the financial stability of the monetary union, which could provoke a rise in long-term interest rates. It should however be recalled that a Member State facing difficulty in terms of public finance sustainability is not allowed to ask for the help of the ECB or of any partner countries, which limits the risks of contagion. If participating countries still had the possibility to conduct domestic fiscal policy as they wish, this would be in contradiction with the decision to create a central bank in charge of maintaining price stability (see box 1).

Box 1. On the compatibility between a single monetary policy and independent national fiscal policies

The functioning of the economy in each Member State may be summarised as follows: $y_i = d_i + g_i - \sigma r$ and $\pi_i = \pi_i^0 + \alpha y_i$, where y_i is the level of output in the country *i* (as deviation from potential output); π_i : inflation rate in the country *i*, expressed as deviation from the central bank's inflation target); π_i^0 : initial inflation (as deviation from the target) or a price shock; d_i: an indicator of private demand and g_i: an indicator of public demand (assumed to be equal to the public deficit); *r*: the single interest rate.

Then it is not possible that each country uses fiscal policy with a view to maintaining full employment, while monetary policy uses the interest rate to keep the aggregate inflation of the area at the desired level. If π_i^0 stand on average above the central bank's inflation target, fiscal and monetary policies will be incompatible. The central bank would raise the interest rate to cut inflation whereas national governments would raise public deficits to maintain full employment. This would lead to a permanent increase in both the interest rate and public deficits (Capoen, Sterdyniak and Villa, 1994).

How can this interdependence be managed? A framework for a permanent co-ordination of fiscal policies and monetary policy could have been designed. This has not been the case in the EMU: it is difficult to imagine how decisions needed to be taken at very short notice could have been conditional on negotiations, with no final agreement being certain to be reached; the agreement would have been imposed on all countries and would have been a direct constraint on fiscal policies, which was politically difficult. It was decided to impose constraints on national fiscal policies through a Stability and Growth Pact. These constraints are not totally rigid. National policies kept some room for manoeuvre which could initially compensate for the fact that the rules were not perfectly adapted. But the institutional logic is such that constraints are getting stronger over time: national authorities are becoming progressively entangled in a 'spider web'.

2.1. The institutional fiscal framework

The monitoring of fiscal discipline is based on four elements: two criteria inherited from the Maastricht Treaty: the 3% of GDP deficit threshold and the 60% reference value for the ratio of government debt to GDP; an institutional framework to implement fiscal surveillance: the Stability and Growth Pact; a co-ordination process: the Broad Economic Policy Guidelines.

2.1.1. Excessive deficits and the 3% of GDP deficit threshold

According to the article 104 of the Treaty establishing the European Community,[1] 'Member States shall avoid excessive government deficits', with excessive deficits being defined as above 3% of GDP.[2] The European Commission and the Economic and Financial Committee (EFC)[3] prepare reports if (or if the Commission thinks there is a risk that) government deficit exceeds 3% of GDP. If the Commission considers the deficit to be excessive, it addresses an opinion to the Council. On a recommendation from the Commission, the Council, acting by a qualified majority (with no vote from the State concerned), decides whether an excessive deficit exists. If this is the case, the Council addresses recommendations to the country concerned, with a 'view to bringing that situation to an end' within a year.[4] If the country concerned does not implement the necessary measures, it may have to pay fines of between 0.2 and 0.5% of its GDP. However, a country will not be fined in case or 'exceptional circumstances', i.e. if the deficit is generated by an unusual event out of control of the national authorities, or if output has fallen by more than 2% and may avoid any sanction, if partner countries agree, in the event of a fall in GDP of between 0.75 and 2%.

2.1.2. The reference value for the ratio of government debt to GDP

The Treaty establishing the European Community mentions the necessity for Member States to maintain the debt to GDP ratios below a reference level (60%), unless the ratio is 'diminishing and approaching the reference level at a satisfactory pace'. The Commission should prepare a report if the debt limit is breached in a country. In practice, the debt limit has

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[1] Consolidated version, *Official Journal C 340*, 10.11.1997.
[2] Protocol on the excessive deficit procedure, annexed to the Treaty establishing the European Community.
[3] The EFC brings together officials from the Member States' administration (ministerial level) and central banks, from the Commission and the ECB. The composition and the proceedings of the Committee are confidential.
[4] The one-year period as well as the sanctions were defined in the Resolution of the European Council of Amsterdam on the Stability and Growth Pact, 17 June 1997, *Official Journal C236*, 02.08.1997.

not been considered since 1997, since several Member States with debt levels largely above 60% of GDP (Italy, Belgium and Greece) were allowed to join the monetary union. However, it is the relevant criterion to assess fiscal sustainability.

The Article 104 also mentions that the Commission's 'report shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member States'.[5] Until 2002, these elements had also been forgotten.

2.1.3. The Stability and Growth Pact

The SGP was adopted on 17 June 1997 at the European Council of Amsterdam. The Pact sets out a medium-term objective, which is to reach budgetary positions 'close-to-balance or in surplus'. Each country of the euro area has to present a stability programme at the end of each year. Stability programmes present medium-term budgetary programmes including the current year, and the three following years. The stability programme must involve a macroeconomic medium-term projection and all planned budgetary measures. More importantly, it has to target a budgetary position close to balance or in surplus in the medium-run.

These programmes are then evaluated by the Commission and the EFC. Based on these assessments, the Council gives an opinion on the ability of the programme to avoid excessive deficits and to reach a medium-run budgetary position in balance or in surplus. The Council, acting by a qualified majority, may address a recommendation to a given country asking for changes in its stability programme. On a recommendation from the Commission, the Council may then address recommendations to the Member State concerned, if government borrowing shifts away from the path towards the equilibrium, from the medium-term objective, or gets close to 3% of GDP. In practice Member States do not have to follow the recommendation. This was shown for instance twice in 2002 by the French government when it refused first to present a budgetary position in balance in 2004, then not even in 2006.

2.1.4. The broad economic policy guidelines

According to the article 99 of the Treaty, governments co-ordinate economic policies within the Council. This co-ordination is made through the elaboration of the broad economic policy

[5] General Government investment is explicitly specified as gross in the Protocol on the excessive deficit procedure.

guidelines of the Member States and of the Community (BEPGs). A text is first prepared by the Commission in spring each year (the recommendations). The European Parliament formulates an opinion. The text becomes a project at an Ecofin council, acting by a qualified majority. The text is discussed in June at a European council. It is then formally adopted at an Ecofin council. On a report from the Commission the Council, acting by a qualified majority, may address recommendations to Member States where economic policy is not in line with the BEPGs. However, here again, the country is not compelled to follow these recommendations. This happened in February 2001, when Ireland was addressed a recommendation, as its budgetary policy was judged too loose considering the level of Irish inflation. There was a fiscal surplus of 4.4% of GDP in 2000 and Ireland decided not to follow the recommendation from the European authorities.

3. The SGP: an assessment five years after

Public deficits had widened to 5.8% of GDP in 1993 partly under the effect of the German reunification and mainly because of the 1993 recession: high interest rates had made it necessary for Member States to use fiscal policy to support activity. Restrictive fiscal policies run in 1996 and 1997 allowed most candidate countries to join the monetary Union. Budgetary efforts have been relaxed in most countries since then.

3.1. 1997-2000: favourable economic conditions

European economies grew at a rapid pace from 1997 to 2000. The euro area public deficit shrunk from – 2.6% of GDP in 1997 to – 1.0 in 2000 (excluding UMTS licences). Lower interest payments explained 1 percentage point of the reduction, the effects of the economic cycle 1.2 percentage points, whereas discretionary measures increased the deficit by 0.6 percentage point of GDP (see table 3). The cyclical improvement of public finances allowed national government borrowing to move away from the excessive deficits threshold. Owing to faster than anticipated output growth (see table 4), Member States were able to fulfil the objectives of their stability programmes easily. Only Austria and Finland made budgetary efforts over that period (see table 5). At the end of 2000, the governments could announce that government borrowing would be in balance in 2004, while implementing fiscal reforms which were deteriorating public balances in the short-term. In the stability programmes presented at the end of 2000, government borrowing was anticipated to be cut by 0.7% of

GDP between 2000 and 2003 in the euro area, due to lower interest payments (0.3 percentage point) and a positive cyclical effect (1 percentage point). No budgetary effort was planned: there even was a positive fiscal impulse of 0.6% of GDP. The procedures of the SGP were ineffective in this case, since insufficient 'efforts' could not be sanctioned as no distinction was made between structural and total deficits.

Table 3. General government balances in the euro area

Percentage of GDP

	1997	1998	1999	2000	2001	2002
General government balance (1)	– 2.6	– 2.3	– 1.3	– 1.0	– 1.6	– 2.2
Cyclical component (2)	– 0.9/*– 0.4*	– 0.6/*– 0.1*	– 0.3/*0.3*	0.3/*0.9*	0.0/*0.5*	– 0.7/*– 0.2*
Interest payments	4.7	4.4	3.8	3.7	3.5	3.4
Cyclically-adjusted primary balance	3.0	2.7	2.8	2.4	2.0	1.8

(1) Excluding proceeds relative to UMTS licences. (2) *OECD Economic Outlook*, n° 72, December 2002. Italic numbers are those of the Commission, *Spring 2003Economic Forecasts*.

Sources: European Commission, OECD.

Table 4. Euro area GDP growth and general government balances according to the stability programmes

	GDP growth assumptions (%)						General government balance (% of GDP)					
	J99	J00	J01	J02	J03	Actual	J99	J00	J01	J02	J03	Actual
1998	2.8					2.9	– 2.1	– 1.9				– 2.3
1999	2.5	2.2				2.8	– 1.7	– 1.4	– 1.2			– 1.3
2000	2.6	2.8	3.3			3.5	– 1.5	– 1.1	– 0.7	– 0.8		– 1.0
2001	2.6	2.5	3.1	1.7	1.5	1.5	– 1.0	– 0.8	– 0.6	– 1.2	– 1.6	– 1.6
2002		2.5	2.9	1.9	1.0	0.9*		– 0.6	– 0.3	– 0.9	– 2.2	– 2.2*
2003		2.5	2.8	2.6	2.1	1.0*		– 0.2	0.0	– 0.5	– 1.8	– 2.5*
2004			2.8	2.6	2.6	2.3*			0.4	0.1	– 1.1	– 2.4*
2005				2.6	2.6					0.3	– 0.6	
2006					2.6						– 0.2	

* European Commission, *Spring 2003 Economic Forecasts*.

Sources: European Commission, Stability programmes, OFCE's calculations.

The European authorities (the ECB, the Commission) deplored that Member States did not use the cyclical improvement to bring more rapidly their deficits close to balance. According to the Commission, the 1% of GDP government borrowing in the euro area in 2000 amounted to 1.7% in structural terms. Despite the fact that the unemployment rate was standing at 8.5% the Commission estimates that there was a positive output gap of 1.6% in the euro area. The 1.7% of GDP budgetary effort needed to bring budgetary positions in balance in 2004 should have been made during the 1997-2000 period, when cyclical conditions were favourable. Unfortunately, the existing European procedures could not impose it. The Commission blames Member States for having run pro-cyclical expansionary policies in that period.

But this reasoning was questioned by a second interpretation for three reasons, which governments did not dare to publicly express. First, the euro area should not accept to live with an unemployment rate of 9.3%, which is the Commission's estimate of the equilibrium unemployment rate. Europe should target an unemployment rate of 5%, which requires output growth of at least 3% for the five coming years, instead of 2.3% as the Commission implicitly states it. If this objective for unemployment is credible, it means that there was a negative output gap of around – 3.5% in 2000 and a cyclically-adjusted budget surplus of 0.7% of GDP. No restrictive fiscal policy was therefore needed. Output growth would bring budgetary positions in balance. Second, a cyclically-adjusted deficit of 3% of GDP allows the debt level to stabilise at 60% of GDP in an economy growing at an annual rate of 5% in nominal terms. A deficit of 1.5% of GDP allows for some decline in the debt level ratio. The euro area considered as a whole had therefore significant budgetary room for manoeuvre (of around 2 percentage points). Last, a country with high unemployment and rapid GDP growth without inflationary pressures may prefer to see the continuation of this economic cycle for as long as possible. The country may decide to undertake necessary fiscal reforms (like tax cuts or lower social contributions) rather than endanger growth with the implementation of a restrictive fiscal policy, especially as there is no certainty that budgetary efforts will be offset by monetary loosening.

Many euro area economies benefited from exceptional fiscal receipts in 1999 and 2000. These countries decided in the course of these years to launch tax cuts programmes which were not announced in their stability programmes. Consequently stability programmes appeared to provide virtual rather than real commitments. The Commission then started to ask that countries shall submit any major policy change to the European authorities. But governments wish to keep their capacity of action and reaction.

Table 5. Fiscal policies in the euro area

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
General government borrowing, % of GDP														
Germany	– 2.0	– 2.9	– 2.6	– 3.1	– 2.4	– 3.3	– 3.4	– 2.7	– 2.2	– 1.5	– 1.4	– 2.8	– 3.8	– 3.3
France	– 2.1	– 2.4	– 4.2	– 6.0	– 5.5	– 5.5	– 4.1	– 3.0	– 2.7	– 1.6	– 1.3	– 1.5	– 2.7	– 2.9
Italy	– 11.8	– 11.7	– 10.7	– 10.3	– 9.3	– 7.6	– 7.1	– 2.7	– 3.1	– 1.8	– 1.7	– 2.2	– 2.4	– 2.1
Spain	– 4.2	– 4.3	– 4.0	– 6.7	– 6.1	– 6.6	– 4.9	– 3.2	– 2.7	– 1.1	– 0.6	– 0.1	0.0	– 0.1
The Netherlands	– 5.7	– 3.2	– 4.4	– 3.6	– 4.2	– 4.2	– 1.8	– 1.1	– 0.7	0.4	1.5	0.1	– 0.8	– 0.6
Belgium	– 6.8	– 7.4	– 8.0	– 7.3	– 5.1	– 4.4	– 3.8	– 2.0	– 0.9	– 0.5	0.1	0.2	– 0.1	0.0
Austria	– 2.4	– 3.0	– 2.0	– 4.2	– 5.0	– 5.3	– 4.0	– 2.0	– 2.5	– 2.4	– 1.7	0.0	– 1.6	– 1.4
Finland	5.3	– 1.1	– 5.7	– 7.3	– 5.7	– 3.7	– 3.2	– 1.5	1.3	1.9	7.0	4.9	3.2	2.9
Greece	– 15.9	– 11.4	– 12.6	– 13.6	– 9.9	– 10.2	– 7.4	– 4.0	– 2.5	– 1.9	– 1.8	– 1.2	– 1.1	– 1.0
Portugal	– 4.9	– 5.8	– 2.9	– 5.9	– 5.9	– 4.4	– 3.8	– 2.6	– 2.4	– 2.9	– 3.2	– 4.1	– 3.4	– 3.0
Ireland	– 2.8	– 2.9	– 3.0	– 2.7	– 2.0	– 2.2	– 0.2	1.2	2.4	2.2	4.4	1.7	– 0.5	– 1.3
Euro area	– 4.9	– 5.2	– 5.4	– 5.8	– 5.1	– 5.0	– 4.3	– 2.6	– 2.3	– 1.3	– 1.0	– 1.5	– 2.2	– 2.1
Fiscal impulses, % of GDP *														
Germany	3.0	0.6	– 0.8	– 1.2	– 0.4	0.6	– 0.3	– 0.7	– 0.3	– 0.4	0.7	0.9	0.4	– 0.5
France	0.3	– 0.1	1.4	0.6	– 0.5	– 0.2	– 2.0	– 0.5	– 0.2	– 0.4	0.5	0.0	0.9	– 0.1
Italy	– 1.1	– 1.7	– 2.4	– 1.7	0.9	– 1.1	– 0.6	– 1.8	1.4	0.3	0.5	0.6	0.1	0.0
Spain	1.0	0.0	– 1.8	0.3	– 0.5	– 0.4	– 1.8	– 0.8	0.5	– 0.5	0.2	– 0.5	– 0.4	0.1
The Netherlands	1.6	– 3.0	0.6	2.0	– 1.2	– 0.6	– 2.2	– 0.3	0.4	– 0.6	– 0.3	0.9	– 0.5	– 0.4
Belgium	– 0.9	0.7	0.1	– 2.2	– 0.5	– 0.2	– 0.8	– 0.1	– 0.8	0.9	0.3	– 0.7	–0.1	0.4
Austria	– 0.4	0.5	– 1.1	1.3	0.9	0.0	– 1.5	– 1.6	1.0	0.1	– 0.4	– 1.5	1.3	– 0.1
Finland	1.1	1.4	1.1	– 1.7	– 1.5	0.0	– 0.1	0.0	– 1.5	– 0.1	– 2.9	1.0	0.9	0.5
Greece	– 1.3	– 2.5	– 1.4	– 1.3	– 4.8	2.9	– 2.0	– 0.7	– 1.4	0.2	0.8	0.9	0.1	0.3
Portugal	1.1	1.7	– 3.0	2.6	– 0.6	– 1.0	0.7	0.5	0.8	0.2	1.0	0.4	– 1.2	– 1.0
Ireland	2.0	– 0.5	– 0.2	– 0.7	– 0.6	1.7	– 1.0	– 0.3	– 0.5	1.7	– 0.8	3.4	1.7	– 0.4
Euro area	0.9	– 0.2	– 0.7	– 1.1	– 0.1	– 0.1	– 1.1	– 1.0	0.2	– 0.1	0.4	0.2	0.2	– 0.1

* Opposite of the variation of the cyclically-adjusted balance excluding interest payments. A positive number indicates an expansionary policy.

Sources: OECD *Economic Outlook,* authors' calculations.

3.2. 2001-2003: the difficult years

Public deficits rose gradually under the effect of the economic slowdown in 2001 and 2002. Fiscal reforms or public spending programmes launched in 2000 also contributed to raise public deficits in some countries (Germany, the Netherlands and Ireland). Deficits started to rise again in almost all euro area Member States. A discretionary fiscal policy was all the more needed to support activity that monetary policy was not very active. There was only a slightly positive fiscal impulse in the area. In Germany, where an ambitious fiscal reform had been implemented and where the economy was particularly affected by the economic slowdown, the public deficit reached 3.8% in 2002. Portugal recognised in 2002 that government borrowing had breached the 3% of GDP threshold in 2001 (4.1%). France breached the 3% limit in 2002. Italy used creative accounting to keep the deficit at 2.4%. The Commission addressed a recommendation to the Council to launch the excessive deficit procedure against Portugal (for year 2001) and Germany (for 2002) and recommended the sending of an early warning to France (for 2003) in November 2002. These recommendations were adopted by the Council on 21 January 2003. In April 2003, the Commission sent a recommendation to the Council to launch the excessive deficit procedure against France (for year 2002).

The updates of the stability programmes presented in late 2001 were still counting on a significant economic upturn in 2002. All countries with the exception of France and Ireland were maintaining the objective of balanced or in surplus budgets in 2004. Public deficits in the euro area were expected to be cut by 1.3 of GDP between 2001 and 2004, with lower interest payments contributing to 0.3 percentage point and discretionary measures to 1 percentage point, output being expected to grow at its potential rate. In other words, governments were committing themselves to run restrictive budgetary policies, independently of the economic situation. The 2001 stability programmes highlighted the drawbacks of the procedures of the SGP. It was not realistic to present a 4-year budgetary programme independently of cyclical conditions at the end of 2001. Such programmes can at best set out medium-term structural guidelines for public expenditure and receipts. They cannot be commitments in terms of future government borrowing.

In 2002, two alternative views were opposed. According to some governments, in particular to the French one, it was essential to support activity and to fulfil electoral promises of tax cuts. There is no justification for running a restrictive policy in a period of recession. It would be unpopular, would dampen further activity when there are no inflationary pressures, only to conform to the arbitrary 'diktat' of Brussels. Besides, not conforming to the commitments announced in the stability programme does not entail sanctions. In the view of European authorities, the credibility of SGP procedures is weakened by actual deficits well above targets presented in the stability programmes and by the fact that some governments refuse to introduce corrective measures in order to reach the targets for deficits in 2004. But the warnings of the European authorities were inappropriate to the economic situation and therefore were hardly listened to. The deficit reached 2.2% of GDP in the euro area in 2002 instead of the 0.9% anticipated in the stability programmes released early that year (see table 4).

At the Barcelona summit of March 2002, governments had reaffirmed the target of 0% of GDP deficit for 2004. But this would have required a significant fiscal policy tightening in Germany, France, Italy and Portugal in 2003 and 2004 which has no economic justification. Under the current practice of the European Council heads of government sign a long document prepared by the Commission and the ECF, which deals with a large variety of topics and cannot be discussed in detail. This practice is neither efficient nor democratic. It cannot bind states, their government and parliament. Governments may be reproached to have accepted the introduction of this procedure.

According the Commission Spring 2003 forecasts, only 3 out of the 12 euro area countries will reach close-to-balance or in surplus budgetary positions in 2004: Spain (– 0.1), Belgium (– 0.1) and Finland (3.0). The primary deficit increased by 1.2% of GDP from 1997 to 2002 despite the Commission's exhortations. European procedures seem to have had little impact on national policies. However the deficit is modest in 2002 (2.2% of GDP for the euro area) in comparison with past similar circumstances: the deficit had reached 5% of GDP in 1986 and 4.3% in 1996. According to the Commission, the structural deficit has reached 2% of GDP (see table 6). But this is under the assumption of a very low output gap (0.7% of potential GDP). Therefore the problem is currently not the widening of public deficits but rather that European authorities stay firm on budget targets instead of organising co-ordinated economic policies to support activity.

Table 6. Cyclically-adjusted balances in 2002

Percentage of GDP

	European Commission		OECD	
	Structural	Structural Primary	Structural	Structural Primary
Austria	– 1.6	2.2	– 1.1	1.2
Belgium	0.2	6.3	0.9	6.5
Finland	3.7	6.3	4.3	4.9
France	– 2.7	0.5	– 2.5	0.3
Germany	– 3.3	0.0	– 2.7	0.3
Greece	– 1.7	3.9	– 1.3	4.4
Ireland	– 1.4	0.2	– 1.4	– 1.7
Italy	– 1.8	4.0	– 1.6	3.8
The Netherlands	– 0.6	2.7	0.4	3.0
Portugal	– 3.0	0.0	– 2.9	0.2
Spain	– 0.1	2.8	0.3	3.1
Euro area	– 2.0	1.8	– 1.6	1.8

Sources: European Commission, *Autumn 2002 Economic Forecasts*; *OECD Economic Outlook n°72*.

The 2002 updates of stability programmes predict a negative fiscal impulse of 0.5% of GDP each year in 2003 and 2004 and of about 0.3% of GDP each year in 2005 and 2006 in the euro area (see table 7). This is particularly worrying as output growth prospects are uncertain for these years, especially for 2003. Deficits are expected to shrink from 2.2% of GDP to 0.1% of GDP in 2006, with cyclical improvement contributing to 0.35 percentage point only, lower interest payments to 0.25 percentage point and budgetary efforts to 1.6. Germany, Portugal, Italy and the Netherlands have endorsed significant restrictive budgetary measures in 2003 (1.3% of GDP for Germany and Portugal, 0.6% of GDP for Italy, 0.4% of GDP for the Netherlands), but France has decided to postpone them to 2004. Almost all countries say they will reach the close-to-balance target in 2006. However, this is conditional on an annual 3% real GDP growth in Italy. Germany anticipates a negative fiscal impulse of 1% of GDP per year during four years. The French deficit is expected to remain around 1% of GDP in 2006, after three years of negative fiscal impulse of an annual 0.4% of GDP. Outside the area, the British government anticipates a deficit of 1.5% of GDP to finance higher public investment spending.

Table 7. Stability programmes, early 2003

	2001	2002	2003	2004	2005	2006
Real GDP growth, %						
Germany	0.6	0.5	1.5	2.25	2.25	2.25
France	1.8	1.2	2.5	2.5	2.5	2.5
Italy	1.8	0.6	2.3	2.9	3.0	3.0
Spain	2.7	2.2	3.0	3.0	3.0	3.0
The Netherlands	1.3	0.25	0.75	2.75	2.75	2.75
Belgium	0.8	0.7	2.1	2.5	2.5	2.5*
Austria	0.7	0.9	1.4	2.0	2.5	2.5
Finland	0.7	1.6	2.8	2.6	2.5	2.4
Portugal	1.7	0.7	1.3	2.7	3.1	3.5
Greece	4.1	3.8	3.8	4.0	3.7	3.6
Ireland	5.7	4.5	3.5	4.1	5.0	5.0*
Euro area	1.5	1.0	2.1	2.6	2.6	2.6
General government balance, % of GDP						
Germany	– 2.8	– 3.8	– 2.8	– 1.5	– 1.0	0.0
France	– 1.4	– 2.8	– 2.6	– 2.1	– 1.6	– 1.0
Italy	– 2.2	– 2.1	– 1.5	– 0.6	– 0.2	0.1
Spain	– 0.1	– 0.2	0.0	0.0	0.1	0.2
The Netherlands	0.1	– 0.7	– 1.0	– 0.7	– 0.4	0.1
Belgium	0.4	0.0	0.0	0.3	0.5	0.5*
Austria	0.3	– 0.6	– 1.3	– 0.7	– 1.5	– 1.1
Finland	4.9	3.8	2.7	2.1	2.6	2.8
Portugal	– 4.2	– 2.8	– 2.4	– 1.9	– 1.1	– 0.5
Greece	– 1.2	– 1.1	– 0.9	– 0.4	0.2	0.6
Ireland	1.6	– 0.3	– 0.7	– 1.2	– 1.2	– 1.2*
Euro area	– 1.5	– 2.2	– 1.8	– 1.1	– 0.7	– 0.1
Fiscal impulse , % of GDP**						
Germany		0.3	– 1.3	– 1.2	– 0.4	– 0.9
France		0.8	0.1	– 0.4	– 0.4	– 0.5
Italy		– 0.6	– 0.6	– 0.3	0.0	0.0
Spain		0.0	0.0	0.1	0.1	0.1
The Netherlands		– 0.2	– 0.4	0.0	0.0	0.0
Belgium		0.0	0.2	0.1	0.2	0.3
Austria		0.6	0.6	– 0.5	1.2	– 0.1
Finland		0.7	1.3	0.8	– 0.5	– 0.1
Portugal		– 1.8	– 1.3	– 0.5	– 0.7	– 0.3
Greece		0.7	0.1	0.1	0.2	0.2
Ireland		1.6	– 0.6	– 0.4	– 0.6	– 0.1
Euro area		0.2	– 0.5	– 0.5	– 0.2	– 0.4

* Figures for Belgium and Ireland kept unchanged in 2006 as compared to 2005. * Opposite of the variation of the cyclically-adjusted balance excluding interest payments. A positive number indicates an expansionary policy.

Sources: *Stability programmes*, Fourth updates, end 2002/early 2003. Own calculations.

4. Weaknesses of the existing framework

The fiscal policy institutional framework of the euro area raises a number of problems. What is its objective? If the objective is to avoid that a country generates negative externalities on partner countries, then the rules should bear directly on these externalities, on the level of domestic inflation or the default risk of public finances. If the objective is economic policy co-ordination, then the ECB and the Member States should discuss and define openly the policies to be implemented in Europe, taking into consideration the different cyclical conditions in Member States. Last, if the objective is to adopt a common economic policy then a democratically elected economic government of Europe should be settled.

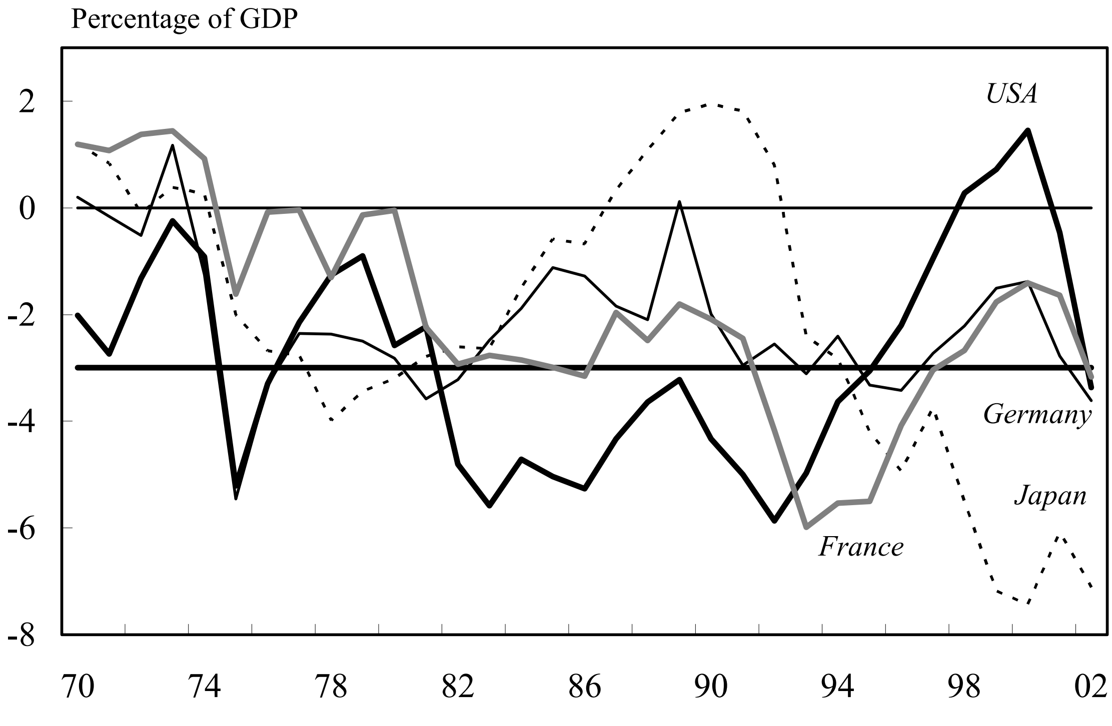
4.1. The rationale for the 3% of GDP reference value

The 3% ceiling is the absolute reference in the current budgetary framework. However, it has no economic rationale. The reasons given are awkward. A deficit of 3% of GDP would stabilise the debt level at 60% of GDP under a nominal GDP growth of 5%. But in that case the reference should apply to the cyclically-adjusted balance or to the average balance over an economic cycle. The 3% figure would be close to the share of public investment in the EU GDP. But, there again, the reasoning can apply only to cyclically-adjusted deficits. The level of the deficit would need to be compared to the level of public investment, so that a country implementing public investment programmes would be entitled to a higher deficit. Last, the ratio of net investment to GDP, net investment being the relevant variable in that case, stands only around 1.5% on average.

A country hit by a specific shock and falling into recession may need a higher than 3% of GDP deficit to compensate for the fall in domestic private demand. *A priori*, this does not raise inflation in the area. Such a deficit could even benefit partner countries since it will avoid the fall in domestic demand which would otherwise have a negative impact on partner countries. In 2002, the public deficit reached 3.8% of GDP in Germany, but inflation was low (1.4%) and the current account was in surplus (1.9% of GDP). It is difficult to claim that the German public deficit generates negative spill-over effects in the rest of the area. If there was to be a negative externality, it would rather be the fact that the low level of demand impedes partners' exports to Germany and thereby has a negative impact on GDP growth in these countries. Conversely, the current procedures do not prevent a specific country from having an excessively high inflation, which will induce excessively high interest rates and may in practice have a negative impact on partner countries. Inflation was growing at an annual rate of 5.1% in the Netherlands in 2001 while government borrowing was in balance.

In the past, the 3% of GDP figure has been breached quite often in the industrial world. This occurred in the US in 1975, 1976, and from 1982 to 1995, in Japan from 1978 to 1980 and since 1995; in Germany, in 1975, 1976, 1981, 1982, 1991, 1993, 1995, 1996; in France in 1985, 1986 and from 1992 to 1997 (see Chart 1). Public deficits were then judged necessary to support activity. It could be different now only if monetary policy was more growth-oriented than in the past. But this is not the ECB remit. Anyhow, with a single monetary policy and different national cyclical positions, monetary policy cannot react to a country-specific cyclical slowdown (see table 8). Hence euro area countries should be given larger budgetary room for manoeuvre, since they can no more use the exchange rate and interest rates.

Chart 1. General government net lending



Source: *OECD Economic Outlook,* excluding proceeds relative to UMTS licences in the euro area.

The absolute 3% of GDP limit places governments before the following alternative: either they bring the cyclically-adjusted deficit down to zero, so that some 'cyclical room for manoeuvre' becomes available; or they maintain some cyclically-adjusted deficit thereby loosing any cyclical room for manoeuvre. Some authors (Artis and Buti, 2001, or Barrell,

2001) evaluate the level of the structural deficit needed in each country to prevent public deficits from rising above 3% of GDP in downturns. But such structural deficits estimates are not optimal, since they are conditional on the arbitrary 3% ceiling. There is no certainty that a single interest rate will lead such levels of public deficits to be equilibrium ones for each country, independently of the strength of domestic private demand.

Norms for public deficits do not necessarily imply that countries will fulfil the inflation target. A country with buoyant private demand may have both high inflation and a fiscal surplus. Such norms restrict the possibility for countries to run countercyclical fiscal policies. Each country of the area will face falls in domestic production if demand or inflation are high in partner countries (see box 2). Conversely, the fiscal policy needed to stabilise domestic demand levels and to keep inflation under control, is such that a country operating at below capacity should be entitled to run some public deficit whereas countries in a better cyclical position should run some budget surplus.

Table 8. Interest rates, GDP growth and inflation forecasts for 2003, January 2003

	GDP growth, %	Consumer prices, %	Differential (1)	Output gap	Interest rate target (2)
Germany	0.9	1.2	0.7	– 2.1	1.75
Austria	1.7	1.7	– 0.6	– 1.4	3.6
Belgium	1.6	1.6	– 0.4	– 0.8	3.55
Spain	2.5	3.1	– 2.8	– 0.7	6.55
Finland	2.6	1.9	– 1.7	– 1.8	4.2
France	1.6	1.7	– 0.5	– 0.6	3.8
Greece	3.6	3.3	– 4.1	0.8	7.6
Ireland	3.6	4.5	– 5.3	5.0	12.5
Italy	1.4	2.1	– 0.7	– 1.6	3.6
The Netherlands	1.0	2.5	– 0.8	– 1.8	5.1
Portugal	1.4	2.8	– 1.4	– 1.3	4.55
Euro area	1.4	1.7	– 0.3	– 1.3	3.45

(1) Differential between the short-term interest rate (2.75%) and consumer price inflation plus real GDP growth forecasts for 2003 (as of January 2003).

(2) Defined as $r = g + \pi + 0.5(\pi - 1.5) + 0.5(y - \overline{y})$ where g: potential output growth, π: inflation rate and $(y - \overline{y})$: OECD's output gap.

Sources: Consensus Economics, *OECD Economic Outlook*, n° 72, December 2002, own calculations.

Box 2. Stabilisation policies and fiscal rules

There is no evidence that different countries having the same interest rate may and should implement the same fiscal policy. Let us consider the model presented in box 1. In order to reach the single inflation target, each country has to target a level of output such as: $y_i = -\pi_i^0 / \alpha$. The central bank, considering the aggregated situation of the area, will set the interest rate as: $r = (\Sigma d_i + \Sigma \pi_i^0 / \alpha) / n\sigma$; i.e. at the level which allows reaching the inflation target with government budget in balance (n being the number of countries assumed to be of similar size). It follows that each country should be allowed to run a public deficit of: $g_i = -d_i - \pi_i^0 / \alpha + (\Sigma d_i + \Sigma \pi_i^0 / \alpha) / n$. National deficits will differ so as to take account of different national cyclical positions and to equalise inflation rates. *Ex post* the level of output in each country will depend only of domestic factors.

Conversely, let us assume that each country is requested to keep its deficit at $g_i = 0$. Under the Central bank's interest rate rule, domestic outputs levels are: $y_i = d_i - (\Sigma d_i + \Sigma \pi_i^0 / \alpha) / n$. These levels do not allow each country to reach the inflation target. Each country can only let domestic output fluctuations depend on domestic demand and will therefore run a sub-optimal policy. Each country is negatively affected by rising demand or inflation in partner countries.

4.2. The rationale for medium-term budgetary positions in balance

The rationale for a medium-term balanced budget has no clear economic justification either. A country where private savings are spontaneously too low (high) may need some budget surplus (deficit). It is also reasonable to finance public investment through government borrowing and therefore some public deficit may be justified. The justification given by the Commission is that budgetary positions in balance will allow policies to react to normal cyclical fluctuations without breaching the 3% of GDP limit (itself arbitrary).

In a situation of relatively low private demand, running a government budget in balance may require such a low level of interest rate that the objective will be out of reach. From 1970 to 2002, the budget was in surplus in the US only from 1998 to 2000 (3 years over 33); in the UK in 1970, 1971, 1988, 1989 and from 1998 to 2001 (8 years over 33). This never happened in the euro area;[6] in Germany in 1970, 1973, 1989 (3 years over 33), in France from 1970 to 1974, in 1977 (6 years over 33). The Pact intends to impose as a permanent reference a

[6] Except in 2000, when a slight surplus of 0.1% of GDP was artificially reached owing to proceeds relative to UMTS licences.

situation which occurred only rarely in the past.

A deficit kept in permanence at 0% of GDP would lead nominal public debt to be stable and constantly declining as a percentage of GDP. The debt would reach 0% of GDP at some point. But savers, in particular pension funds, need to own public assets, which are long-term, liquid and safe assets. If savers wish to own financial assets while private companies are reluctant to increase borrowing, a 0% of GDP public deficit and debt may require low long-term interest rates, below GDP growth, which would not be optimal. If households wish to own more bonds and firms are reluctant to borrow, a country which controls the domestic interest rate may cut it in order to match supply and demand. On the contrary, in a country which does not control interest rates, higher public deficits and debts are needed. Paradoxically, the independence of the central bank is a major cause for higher public deficits (Creel and Sterdyniak, 1995). A more reasonable medium-term objective would be the stability of a debt to GDP ratio at 40% for instance. This would require a cyclically-adjusted deficit of less than 1.8% of GDP, with nominal GDP rising by 4.5% a year, which represents a budgetary effort significantly lower than requested by the Commission.

4.3. The SGP and economic policy co-ordination

The justifications for the Stability Pact combine reasonably sound considerations on the need to avoid the negative externalities that a given national fiscal policy could have on partner economies, and more arguable considerations on the inefficiency of discretionary fiscal policies, on the expansionary bias and on the risk of non sustainable fiscal policies run by democratically elected governments.

The procedure of the stability programmes implies that governments are able to make reliable forecasts on a 4-year horizon, and to commit themselves to implementing a fiscal policy in line with this projection. Governments are likely to be tempted to present an optimistic forecast, showing strong and sustained output growth bringing government borrowing in balance in a four-year time. But what shall be done if GDP growth turns out to be lower than forecast? If a depressive shock occurs, should countries keep their fiscal policy stance unchanged? Should they stick to the forecasted deficits (meaning in practice tightening their policies) or should they rather maintain announced public spending and taxation (meaning accepting rising deficits)? Forecasting economic activity without errors is impossible in practice, even on a 1-year horizon. Hence one cannot expect stability programmes to give an exact image of the future. The procedure of an annual submission of stability programmes generates permanent tensions between governments wishing to keep the possibility to adapt fiscal policy to the current circumstances and the Commission claiming for a strict fulfilment of the stability programmes.

Fortunately, the horizon for budgetary positions to be in balance is a medium term one. This could have left room for a soft interpretation of the provisions of the Pact, where the medium run target would have been indicative. The objective started to be more binding when a given year was chosen for government borrowing to be in balance (2002, then 2004, then 2006) independently of the cyclical situation.

If the procedure was strictly followed, it would put a strong constraint on fiscal policy in the countries where fiscal deficits remain. For example, general government borrowing reached 3.1% of GDP in France in 2002. If the French government wants to fulfil the commitment made in Seville in 2002 to reach a budgetary position in balance in 2004, the public deficit will have to be cut by 1.5% of GDP both in 2003 and in 2004. This means a restrictive policy will have to be run these two years, independently of the economic situation. The lower output growth, the strongest the budgetary effort. Fiscal policy is necessarily pro-cyclical in the path towards equilibrium.

In theory, stability programmes put strong constraints on fiscal policies. In practice, coalitions have happened to emerge in the Council not to vote the recommendations from the Commission (it should be noted that the state concerned takes part to the vote). Moreover, Member States are not compelled to follow the recommendation as long as their deficit remains below 3% of GDP. This is the 'bad example' shown first by Portugal and Germany in February 2002, to avoid the adoption of a warning against the risk of an excessive deficit recommended by the Commission. These two countries have however committed themselves to run restrictive fiscal policies in order to bring their budgetary position in balance in 2004. France did worse in September 2002 when the government refused to present a stability programme showing a budgetary position in balance in 2004, and not even in 2006.

The Commission does not want to set a target of economic growth in Europe and to define a strategy to reach it. The procedure is not economic policy co-ordination. Monetary authorities do not take part in the process. The cyclical position of the European economy, global or country-specific, is only partly taken into consideration. National stability programmes are evaluated separately, without analysing the impact they will have on partner countries. With the view that automatic stabilisers may be allowed to run only in countries where budgetary positions are in balance, whereas efforts should be intensified in the countries where it is not the case, it is difficult anyway to see what co-ordination the Commission could organise.

The Pact focuses on public finance targets and not on output growth targets. It is therefore not a co-ordination process, but a forced convergence toward *a priori* defined norms. A satisfactory co-ordination process would consist in examining precisely the economic situation of the area as a whole in terms of inflation and output growth in order to set the appropriate level of interest rates, before analysing the compared national situations into detail so as to set the adequate national fiscal policies (see box 3).

Box 3. An illustrative example of co-ordination

Six countries of the same size are assumed to form the area (see table). The *ex ante* demand level is shown in column 1; the level of inflation is shown in column 2 (both being expressed in difference from the objective). The strategy chosen in the example is that any gap between actual inflation and the objective level should be reduced by 50% during the reference period. The desirable situation may then be calculated (columns 3 and 4). The average impulse needed in terms of output is + 0.5. This impulse is provided by monetary policy (column 5). The fiscal policy reaction adapted to each domestic situation is shown in column 6. In this example, countries A, C and D must run an expansionary fiscal policy. Countries B and F where inflation is too high need to run a restrictive fiscal policy and to accept a negative output gap.

Table. An example of economic policy co-ordination

	Initial situation		Targeted situation		Impulse	
	Demand	Inflation	Output	Inflation	Monetary*	Fiscal
A	– 2	0	0	0	0.5	1.5
B	– 1	2	– 1	1	0.5	– 0.5
C	– 1	– 1	0.5	– 0.5	0.5	1.0
D	– 1	0	0	0	0.5	0.5
E	0	– 1	0.5	– 0.5	0.5	0.0
F	1.5	1	– 0.5	0.5	0.5	– 2.5

* Monetary policy: $r = – 0.5$

Note: In each country, production is determined by: $y_i = d_i + g_i - r$; inflation by: $\pi_i = \pi_i^0 + y_i$

4.4. The limits of the BEPGs

The procedure of BEPGs is not much reported in the press and in the public opinion. How could Member States accept to bind their policies to comply with decisions made by technocratic committees without any democratic debate?

The last BEPGs, published in June 2002, do not organise an adequate fiscal policy answer to the economic downturn. The BEPGs refer mainly to structural policies. In line with the

Lisbon strategy objectives, they focus on the main challenge of 'making Europe the most competitive and dynamic knowledge-based economy by the year 2010'. They tell once more the importance of monetary policy targeting price stability and of 'sound' fiscal policies. They focus more on the need to cut deficits than to support activity: the objective remains to improve public finance today so as to be able to use macroeconomic stabilisation in the future. The BEPGs reassert the medium-term strategy: budgetary positions in balance starting from 2004 and in surplus in the medium term in the prospect of ageing populations. On structural issues, the BEPGs advocate in permanence for lower tax to GDP ratios and lower public expenditure as a share of GDP. In our view this should remain a national choice: each country is free to choose the organisation of its retirement, health or education systems.

National fiscal policies are under the control of three Community procedures suffering questionable economic rationale and dubious democratic legitimacy. The European Commission has set a four pillar strategy and tries to impose it on Member States: the 3% limit, the medium-term budgetary position in balance, cuts in public spending and disapproval of discretionary fiscal policies. The institutional functioning is such that the public finance criteria, like the 3% of GDP threshold and the medium-term targets for deficits become objectives as such: the European authorities urge countries to fulfil these objectives, independently of any economic rationale. A deficit higher than 3% of GDP in one country becomes harmful, not because of negative spillovers, but because it endangers the credibility of the Commission's surveillance process. But imposing constraints of supplementary and arbitrary objectives can only impede European countries' ability to support satisfying growth (Fitoussi and Saraceno, 2002).

5. The reforms proposed by the Commission

In July 2001, on a proposal from the EFC, the Ecofin Council adopted the first reform of the procedures (European Commission, 2002*a*). The objective is to provide a 'more effective surveillance'. Countries shall present their annual stability programme before 1 December. The assumptions for the world economy outside the European Union shall be provided by the Commission. Domestic policies have to be in line with the BEPGs. The medium-term target must fulfil the rule of balanced budgets. But it also has to enable a rapid decline in the debt to GDP ratio and to provide room for manoeuvre for future ageing-related expenditure. The stability programmes will have to incorporate a projection of the impact of ageing populations on public finance sustainability. Member States will be asked to commit themselves to undertake in the course of the year the correcting measures necessary to reach the targets set in their plans. The assessment of the medium-term objective of budgetary positions in balance will have to take account of the cyclically-adjusted balances as they are estimated by the Commission. However, these cyclically-adjusted balances will not become an objective as such: 'The Pact will not change'. Member States have to bring government borrowing in balance and then to maintain an underlying budgetary position in balance or in surplus.

The reference to ageing populations is a way of putting permanent pressure on countries so that they reduce the burden of old-age pensions public spending or run budget surpluses to guarantee the future funding of pensions. But no country intends to finance the future rise in pension spending through a permanent public deficit, which would be impossible anyway. If a country is willing to finance the future increase in social expenditure through higher social contributions, there will be no impact on partner countries. One may regret that governments have let the Commission introduce the pensions issue in the stability programmes. Besides it is difficult to imagine how countries can fulfil the objectives of their programmes when GDP growth turns out to be much lower than expected. Should pro-cyclical policies be run? This text increases the power of the European authorities and was adopted by the Ecofin council without any public and open debate.

The Commission has requested in February 2002 that each country necessarily asks the opinion of the Commission and of the peer countries before making important economic policy decisions. The risk is that any unorthodox change of policy will be opposed.

On 13 September 2002, speaking before the European Convention, Pedro Solbes, Commissioner for Economic and Monetary Affairs, stated that the functioning of the EMU was satisfactory. However he proposed three reforms. First, the Commission should be entitled to send recommendations directly to the States without any approval from the Council. Second, the Council shall not depart from the Commission's recommendations on BEPGs and on warnings addressed to a member country, unless acting by unanimity. Last, a Member State concerned should not take part to the vote on warning. Pedro Solbes also proposed the creation of an 'Ecofin Council for the euro area', which would prevent Member States outside the monetary union from voting on constraints they are not subject to.

On 24 September, the Commission (Solbes, 2002) recognised officially that the target of close-to-balance budget was out of reach for 2004, even in terms of cyclically-adjusted balance. The government deficit of the euro area was to reach at least 2% in 2002, instead of 0.9% expected at the end of 2001. Four countries (Portugal, Germany, France and Italy) were accused of having undertaken too expansionary fiscal policies in times of economic growth. The Commission proposed to change the rules of the game to avoid such deviations. But the Commission does no intend to put the Stability Pact into question: 'The experience of the early years shows that the question is not about the framework itself, but how can the system be better managed so that the rules are followed. The 3% of GDP deficit threshold is the cornerstone of our stability framework.' The medium-term target remains close-to-balance or in surplus budgets on average over the cycle. This target cannot be postponed in permanence, or it will loose credibility. The Commission now accepts reasoning in terms of cyclically-adjusted balances. The Commission accepts that the four 'sinners' of the euro area commit no more themselves to reach close-to-balance budgets in 200, under the condition that they will cut structural deficits by at least 0.5% of GDP a year, so that all structural government budgets will be close to balance in 2006. Once this objective is reached, Member States will have to maintain their structural budget at least in balance. Pedro Solbes reasserts the necessity to strengthen fiscal policy co-ordination, but within the Stability Pact. This closes the door on any further discussion. The fulfilment of an *a priori* government budget target cannot be itself an effective co-ordination process

The amendments proposed by the Commission give some room for manoeuvre to the countries currently facing economic difficulties. But it does not solve the problems. Who could say, at the end of 2002, under uncertain cyclical developments, if the optimal economic policy was compatible with an annual 0.5% of GDP reduction in structural deficits? Such a policy makes sense only if interest rates are low and if private demand is robust. But as long as private demand remains weak, fiscal policy should support activity. The rule prescribed by the Commission would deprive national fiscal policies of any room for manoeuvre. However, the proposal was accepted by all countries, with the notable exception of France, the 'non-reformed sinner'.

On 18 October 2002, the President of the European Commission, Romano Prodi, said: 'I know very well that the Stability Pact is stupid, like all decisions that are rigid'.[7] Romano Prodi proposed in a speech before the European Parliament (*A stronger, better Stability and Growth Pact*, 21 October) that economic policy co-ordination should be in the hands of a 'strong authority' which 'can both apply the rules strictly to prevent behaviour that is off-

[7] "Je sais très bien que le Pacte de stabilité est stupide, comme toutes les décisions qui sont rigides", *Le Monde,* 18 October 2002.

course and adapt the rules to changing circumstances'. He also said that 'by its very nature, the Commission is therefore naturally suited to this steering role'.

On 21 November 2002, the Commission (2002*b*) presented a set of measures to 'strengthen the co-ordination of budgetary policies'. These measures aim at strengthening the control of the Commission on national fiscal policies. The Commission deplores that some Member States wish to keep their fiscal autonomy and refuse 'to acknowledge the implication of EMU on the conduct of fiscal policy at national level'. The Commission made five proposals (1-5) and a presented a four-point programme (6-9):

1) The 'close-to-balance or in surplus' requirement of the SGP should be interpreted in terms of cyclically-adjusted budget balances, as estimated by the Commission.

2) National structural deficits will have to be cut by at least 0.5% of GDP per year, even more rapidly in countries having a high deficit or debt, or 'favourable growth conditions'. *These countries have to undertake restrictive fiscal policies, independently of the evolution of their economic cycle.*[8] Once the close-to-balance or in surplus requirement is reached, automatic stabilisers will be allowed to run but expansionary discretionary budgetary policies will not.

3) To avoid the occurrence of expansionary fiscal policies in times of favourable growth, countries must run budget surpluses when they have a positive output gap. *But who will decide that a country has a positive output gap? As soon as a country will enjoy some economic recovery, the Commission will find a positive output gap, as was the case for France from 1999 to 2001, and the country concerned will be asked to implement a restrictive fiscal policy.*

4) The Commission wishes to give its authorisation for a 'small temporary deterioration in the underlying budget position' to the countries which undertake structural reforms in line with the Lisbon strategy. But these countries must have a debt well below 60% of GDP and a low level of implicit debt on public pensions; they must keep a safety margin to avoid breaching the 3% reference value, etc. *Member States are seen as irresponsible, they must ask for an authorisation before acting. This rule is perfectly well adapted to facilitate the British participation in EMU. It does not change the situation for Germany, Italy or France.* [9]

[8] Authors' comments in italics.
[9] This Commission's proposal was subject to criticisms from the Economic and Financial Committee, which sees in it a risk of budgetary leniency (unpublished report, 12 February 2003). There was no unanimity either among Member States on the proposal at the Ecofin Council of 18 February 2003.

5) 'The sustainability of public finances should become a core policy objective'. The Commission wants to give more importance to the debt criterion of the excessive deficit procedure. Countries with debts well above 60% of GDP will have to present debt reduction strategy in their stability programme. *But why countries with a high savings rate should be prevented from having a certain level public debt? Is Belgium public debt worrying when Belgium has a huge external surplus and low inflation? Is the sustainability of public finances more important than subdued activity and persistent high unemployment rates? Is the sustainability of public finances really at risk in any of the euro area countries?* Countries should present each year a programme saying how they intend to face the 'challenge posed by ageing populations'.

6) 'Member States should reaffirm their political commitments to the SGP'. They should endorse a resolution to strengthen fiscal policy co-ordination, including in particular the commitment to cut structural deficits by at least 0.5% of GDP a year, to reduce significantly debt levels when these are higher than 60% of GDP, to facilitate the implementation of the enforcement procedures of the Pact.

7) The Commission wants to take account of the 'quality of the public finances'. The Commission wants to make sure that countries will reduce government borrowing through expenditure cuts and not through higher taxation, and that public spending will be productive. The Commission intends to strengthen its surveillance of Member States, to carry out country studies and to make them public. *But has the Commission been given the role of evaluating the size and the appropriateness of national public spending? In our view public spending is a political choice and must reflect the democratic choices of citizens.*

8) The Commission wants 'more effective enforcement procedures' of the Pact. The Commission wants the early-warning mechanism to be activated more rapidly and more automatically. It wants warnings to be possibly sent to the countries undertaking expansionary policies in good times. It wants the excessive deficit procedure to be possibly launched against countries where insufficient efforts to bring public debts below 60% of GDP are made. The Commission wants to issue early-warnings to Member States without a Council's vote.

9) The Commission wants to have 'a better communication through openness and transparency'. Hence the Commission will publish a report presenting an assessment of national budgetary developments and general orientations of fiscal policies. This report will appear in July each year in the *Quarterly report on the euro area*. Member States will have

take account of the Commission's report in the preparation of their budgets.

The Commission has finally accepted that the assessment of the medium-term target (but not the 3% of GDP limit) will be made in terms of cyclically-adjusted budget balance. But the structural balance is difficult to estimate, since it depends on the calculation of the output gap and therefore of potential output. The method used by the Commission (Denis, Mc Morrow and Röger, 2002) consists in estimating potential output with a production function. Capital is taken as exogenous: in economic slowdowns, capital growth decelerates which, under the method used here, lowers potential output. Labour force is measured as the product of the population of working age, the participation rate and the complement to one of the non accelerating inflation rate of unemployment (NAIRU). The participation rate is also considered as exogenous, whereas it fluctuates in fact in line with the economic situation: a rise in unemployment discourages a part of potentially active workers to search for a job. Last, the NAIRU is measured as a moving average of the actual unemployment rate. Hence potential output growth measured that way tends to reproduce past growth: potential output is estimated to have grown by an annual 2.1% in 1981-1982, 2.8% in 1989-1990, 2% in 1993-1994 and 2.5% in 2000-2001 in the euro area. Potential output fluctuates like actual output. The method underestimates the output gap in times of recession and therefore overestimates the structural deficit. Past slow growth will necessarily have an impact on current potential output. For instance, the Commission estimated that there was a positive output gap of 0.3% in France in 2002 despite an unemployment rate of 8.7% (*Spring 2003 Economic Forecasts*). If output growth were stronger than 2.3% a year in 2003-2004 in France, the Commission would call for a restrictive policy to be implemented.

Reasoning in terms of cyclically-adjusted deficits leaves room for automatic stabilisers to work: in bad times public deficits may rise under the effect of lower fiscal receipts induced by weaker activity. A country will not be asked to raise taxes in times of recession. The problem is that fiscal policy should not go beyond automatic stabilisers in the Commission's view. This has no economic rationale. If fiscal policy is thought to be totally ineffective, because as households are Ricardian they will anticipate future tax rises, then any attempt to run an expansionary policy will fail to boost activity. There will be no rise in inflation and no negative impact on partner countries. In that case co-ordination is useless. If, on the contrary, fiscal policy is thought to have an effect on activity, then fiscal policy co-ordination is useful and there is no reason why fiscal policy should be limited to automatic stabilisers. Discretionary fiscal policy may be useful to strengthen or to reduce the effects of automatic stabilisers. If a given country is hit by an adverse demand shock, the single monetary policy will not be very proactive. A positive fiscal impulse will be needed in order to stabilise domestic output (see box 4). The US government has deliberately run a discretionary fiscal policy to boost activity in 2002 and 2003, which adds to the expansionary monetary policy stance. There is no reason why such polices should be forbidden in Europe. Last, the size of automatic stabilisers varies according to the budget structure (level of the tax to GDP ratio and tax rate progression, weight of unemployment allowances), which is *a priori* unrelated to stabilisation needs.

Box 4. How to stabilise output, government borrowing and public debt: some simple arithmetic

Let us consider a simple model: $y = g + d + c(1-t)y$; where g is a public spending shock, d a private spending shock, c: propensity to consume (considered equal to 0.5), t: tax rate, considered equal to 0.5. The GDP level is 100; ρ, the debt to GDP ratio, is 50.

A fall in private spending (column 1) will lead to a rise in the public deficit and in the debt to GDP ratio *ex post* despite the effect of automatic stabilisers. A rise in public expenditure (column 2), hence of the so-called structural deficit, is necessary to stabilise fully activity. Trying to stabilise government borrowing (column 3) induces a large fall in activity. Moreover, cuts in public expenditure lead to a rise in the debt to GDP ratio because of the fall in activity. It is therefore impossible to bring the debt to GDP ratio down to its initial level through lower public spending. This is true when $\rho > (1-c)(1-t)$.

Impact of a fall in private demand

d = – 1	g = 0	g = 1	g = – 2
Y	– 1.33%	0	– 4%
Government borrowing	– 0.66	– 1	0
Debt to GDP ratio, in %	51.3	51	52.1

The Commission's view reflects its suspicions of national governments. European institutions are dominated by a Community, Technocratic and Liberal ideology. There are no open and transparent choices at the European level between different political options, as should be the case in a democracy. A unique solution is proposed and progressively imposed on all countries. European institutions represent the interest of the European Community. National authorities are selfish and short-sighted. Governments are by nature demagogic since they want to be re-elected. It is necessary to transfer as many decisions as possible from the national to the community level, from the political to the technocratic level. In this respect, the model is the ECB. The institutional logic is such that the Commission has the objective 'to improve European integration', hence to increase its authority at the detriment of the Member States. The Commission's proposals on fiscal policy co-ordination are part of this deviation

Why do national authorities accept this deviation? Because the majority of national technocracies and of political and economic leaders share the CTL ideology. They believe important decisions should be made by technocrats; that nations are no more a relevant level in a global world; that European construction is the last chance for rigid social-democrat societies to move towards more liberal societies. This common view explains how Brussels technocracy can strengthen gradually its power on national issues.

The Commission tries to deprive national governments of any degree of freedom, without implementing an effective economic policy co-ordination in return. This necessarily generates tensions in Europe when the Commission's requirements depart too much from needed macroeconomic stabilisation policies as was the case in 2002.

In early 2003, the Commission wants to have more power on the definition and control of national public finances. But these powers are not in the Treaty and have no democratic legitimacy. The Commission focuses on the levels of public deficits and debts at the expense of unemployment targets or growth prospects. The Commission gives no evidence that the restrictive fiscal policies to be undertaken in France, Germany and Italy in 2003 and 2004 will be favourable to economic growth in Europe. Is it reasonable to give more powers to the non-democratically elected Commission? We do not think so and we hope that Members States will not follow the Commission. As Paul de Grauwe wrote: 'Seen from this political perspective, the Stability Pact is a vote of no confidence of the European authorities in the strength of the democratic institutions in the member countries. It is quite surprising that EU-countries have allowed this to happen, and that they have accepted to be subjected to control by the European institutions that even the IMF does not impose on banana republics.'[10]

At the Eurogroup meeting and Ecofin Council of 18 February 2003, no Member State argued clearly against the Commission's proposals for an in-depth re-examination of the SGP. The only interrogations came from some Member States worried that allowing for small deviations of the medium-term balance rule would weaken the SGP. Belgium, Denmark and Spain voted against the approval of the UK convergence programme, which predicts a structural deficit in 2006, even though this deficit is forecast to remain below net public investment. Thus Pedro Solbes could say at the Eurogroup Press conference of 18 February 2003: 'There is enough flexibility in our rules. (…) It is time that we bring the long debate on the future of the Stability and Growth Pact to an end'.

The Ecofin Council of 7 March 2003 and the European Council of 20-21 March have finally adopted a proposal very close to the Commission's proposal: the 3% of GDP threshold is to be considered in terms of actual deficits, the medium-term target in underlying terms. Countries having a structural deficit will have to cut it by at least 0.5% of GDP a year. Countries with favourable growth conditions will have to avoid procyclical policies. The excessive deficit procedure will have to check that debt to GDP ratios are declining sufficiently rapidly in highly indebted countries. Quality of public finances and long-term sustainability (in the prospect of ageing populations) will be taken into account. This decision was adopted without public debate on the respective roles of European and national institutions, on a fiscal policy framework based on fiscal targets and not on output growth targets.

6. Reforms suggested by academics

The need to reform the SGP has generated a growing literature. We will discuss here recent proposals. Some proposals call for in-depth changes of the economic policy framework. Some others suggest the rules to be changed. Some others call for a change of the procedures.

6.1. Budgetary federalism

The European budget represents only 1.27% of GDP. Spending is dedicated mainly to

[10] *Financial Times*, 22 July 2002.

common agriculture policy and structural funds. The European budget is not expected to increase and cannot be used for short-term stabilisation purposes. So some economists have proposed to create a budgetary mechanism of 'cyclical' transfers between states (see for instance Sala-I-Martin and Sachs (1992), Bureau and Champsaur (1992), Italianer and Pisani-Ferry (1992), Mélitz (1993), Bayoumi and Masson (1995)). Monetary policy would be in charge of the stabilisation policy of the area as a whole; countries would have to run budgets in balance; budgetary transfers from countries in a relatively good cyclical position to countries in a relatively bad cyclical position would stabilise national macroeconomic situations. This organisation has the advantage of cohesion. However, it has never been implemented and has not even been seriously discussed officially. On the one hand, it gives excessive importance to monetary policy. On the other hand, countries would loose fiscal autonomy and would not be allowed to let automatic stabilisers play. A country in recession would be allowed to run a deficit within the bounds of transfers received from partner countries. Moreover, transfers would be centralised at the community level, which would raise difficult issues on the calculation and time schedule of transfers. A country in difficulty would be expected to receive transfers from its partners, but the latter could accuse the former of being responsible for the difficulty (for instance by maintaining excessively high wages). A country enjoying rapid growth would be asked to pay a high contribution, which it might find unfair if this rapid growth results from specific domestic efforts (in terms of savings, wages or reforms). Transfers setting would lead to never-ending debates. Therefore, the proposal does not seem easy to implement.

6.2. Cyclically-adjusted balance

It has been widely advocated by economists that fiscal rules should refer to cyclically-adjusted borrowing. Despite initial ambiguities, the Commission has recognised since 2002 that the medium-term target of budgetary positions in balance should be understood in terms of cyclically-adjusted deficits. Contrary to what happened in the selection process of the first members of the monetary union in 1997, countries are not requested to make efforts in order to reach a 0% of GDP deficit in a given year. Yet four issues remain open. If a deep economic recession occurs in the reference year, countries should be allowed to run some discretionary cyclical deficit (to draw on a terminology from Creel and Sterdyniak, 1995) resulting from temporary stabilisation measures. We have already seen that it is difficult to calculate cyclically-adjusted government borrowing. The reference of a 0% of GDP structural balance remains arbitrary. Last, the 3% of GDP threshold still apply to actual government borrowing.

Coricelli and Ercolani (2002) suggest that each country shall be compelled to keep public spending in year t at the level of fiscal receipts which would be generated by potential output of year t. At the end of year t-1, a committee of experts would verify that budget for year t complies with the rule. During year t, the country would have to stick to its spending and tax rates plans. This procedure would replace the 3% of GDP threshold. Structural borrowing would necessarily be zero. The four problems previously mentioned also arise here.

6.3. The golden rule for public finances

A large number of economists have shown that it is desirable in economic terms that public investment, which will be used over several years, be financed over a similar period of time.[11] Independently of any short-term stabilisation consideration, government budgets should be split into a current budget which should be in balance and where spending would include public capital stock depreciation, and an investment budget, which will have to be financed through borrowing. The UK government adopted such a rule, the so-called 'golden rule for public finances', in 1998.

In recent years, several economists (Modigliani *et al.*, 1998, Creel *et al.*, 2002, among others) have proposed to import this rule in the euro area: structural current government borrowing, *i.e.* excluding public investment, should be permanently in balance or in surplus. Their proposal differs in two respects from the British rule. In the UK, 'over the economic cycle, the Government will borrow only to invest and not to fund current spending', meaning the current budget has to be in balance over a cycle. Hence, the British government accepts to see government borrowing rise under the effects of both automatic stabilisers and discretionary measures in times of economic recession as long as this rise will be offset by surpluses in good times. This is not the case in the mentioned proposals. Another ambiguity is the definition of public investment. The UK golden rule refers to net public investment, while Creel *et al.* (2002) seem to advocate for a rule on gross investment.

Let us assume that a country wishes to maintain public debt at the level of public capital

[11] This view was developed at the end of the 19th century by Leroy-Beaulieu (1891) and Jèze (1896). It can also be found for instance in Musgrave (1939) or Eisner (1989).

stock.[12] Public debt in real terms is determined by: $D = D_{-1}(1+r-\pi) - s_p$, where s_p is primary budget surplus. Public sector capital stock is determined by: $K = K_{-1} + I - \delta K_{-1}$. $D = K$ implies that budget surplus: $s = s_p - rD_{-1} = -(I - \delta K_{-1} + \pi D_{-1})$. The correct interpretation of the *golden rule* is therefore that the cyclically-adjusted borrowing, net of net public investment and of debt depreciation should be at least in balance.

According to the golden rule, borrowing may finance public investment, which is important in particular for countries which have are significant investment needs. Buiter and Grafe (2003) highlight the case of the future members of the European Union. Under this rule, countries will not cut public investment to improve government borrowing. Lowering public investment is harmful in terms of potential output growth if endogenous growth theory has some relevance. But it opens the Pandora box on the definition of public investment: should the definition of national accounts be the reference, or should all spending preparing for the future, like education or research be also taken into account, as proposed by Fitoussi (2002)? The rule also introduces a risk that governments increase public investment for short-term stabilisation purposes only.

Balassone and Franco (2001) reject this rule in the name of the difficulties of measure. The rule implies that statisticians are able to estimate the cyclical part of government borrowing (therefore the output gap and its impact on public finances), public investment and public capital stock depreciation, in other words four measures that may be questioned. But is not it better to use a fair rule, estimated with a low degree of precision than to follow a wrong rule, estimated with precision?

A more fundamental criticism is that this rule defines the neutrality of fiscal policy, cyclical neutrality (only automatic stabilisers are allowed to work) and structural neutrality (public savings equals public investment). But a government may choose not to be neutral. It may wish to implement an expansionary fiscal policy in times of subdued activity or may wish to run a restrictive policy in a period a high inflation. It may wish to implement structural measures if it thinks that saving is too high *ex ante* (which would necessitate a too low interest rate) or too low (in the light of demographic changes). The proposed rule confuses a criterion of neutrality with a norm for economic policy. As with the existing rule, there is no

[12] Blanchard and Giavazzi (2002) also look for a condition that would assure that public debt remains equal to public capital stock. But they make the assumption that there is no inflation. Hence they forget debt depreciation.

certainty that the fiscal policy needed to reach a satisfying level of activity in a country which does not control the interest rate matches the golden rule.

As shown in table 9, the four indicators give different results for public deficits. For instance, Italy's structural deficit amounted to 1.9% of GDP in 1999, but turned into a surplus of 0.6% in terms of structural balance net of gross investment. There was a structural deficit of 0.7% excluding net public investment, which turned into a surplus of 1.2% excluding debt depreciation.

Table 9. Four indicators for government borrowing (in 1999)

Percentage of GDP

	Cyclically-adjusted balance (CAB) (1)	Gross public investment (PI) (2)	Public capital depreciatio n	Public debt depreciatio n (DD)	CAB + gross PI	CAB + net PI	CAB + net PI + DD
Germany	– 1.4	1.8	1.7	0.3	0.4	– 1.3	– 1.0
France	– 2.0	3.0	2.2	0.3	1.0	– 1.2	– 0.9
Italy	– 1.9	2.5	1.3	1.9	0.6	– 0.7	1.2
UK	0.8	1.1	0.9	1.1	1.9	0.8	1.9

(1) According to the European Commission. (2) Public investment refers to general government investment.

Sources: European Commission, *Autumn 2002 Economic Forecasts*; OECD, *National Accounts, Volume II – 1989-2000* (2002).

Let us consider a country where the economic cycle is such that there is a 3% of GDP output gap in the trough of the cycle and where the elasticity of government borrowing to GDP is 0.5. Public debt amounts to 50% of GDP, inflation to 2% and gross public investment represents 3% of GDP with a depreciation of 2%. In comparison with the existing rule, a rule under which countries would have to keep their structural current budget in balance (excluding gross public investment), gives a 3% of GDP supplementary margin on average over the cycle (see table 10), but it is not justified from an economic point of view. A rule based on structural balance excluding public net investment provides only a 1% of GDP supplementary margin on average. In the trough of the cycle, this rule is more restrictive than the existing one. If debt depreciation is taken into account, the improvement is very small as compared to the current rule in cyclical troughs (0.5% of GDP) but significant on average (2% of GDP).

Table 10. A comparison of four fiscal rules

Percentage of GDP

	SGP	CAB+GPI	CAB+NPI	CAB+NPI+DD
Government borrowing needed				
— On average over a cycle	0	– 3	– 1	– 2
— In the trough of the cycle	– 3	– 4.5	– 2.5	– 3.5

Should a better than the current rule be proposed? All fiscal rules based on government borrowing do not take into account the fact that public finances are only tools to support activity or to regulate the savings/investment equilibrium. Any proposal for a European fiscal rule, under the control of the Commission, neglects the fact that the surveillance of public finances in EMU should aim at avoiding that a country generates negative spill-over effects in partner countries rather than trying to define optimal national fiscal policies at the European level.

6.4. A permanent balance rule

In a similar approach, Buiter and Grafe (2003) and Buiter (2003) propose a *permanent balance rule*. Under this rule, the tax rate would be determined in permanence as: $t = g^p + (r^p - \pi^p - n^p)b$, where g^p is the permanent level of primary public spending in % of GDP, in other words the stable level of spending in % of GDP which would have the same discounted value than anticipated public spending; r^p ,π^p and n^p are respectively the permanent (i.e. on average over a cycle) interest rate, inflation rate and output growth; b is the debt to GDP ratio. With this *a priori* constant tax rate, anticipated public spending would be financed while public debt would be stabilised. The stability of the tax rate is optimal since it minimises the distortions arising from taxation.

In the short run, the budget balance would be: $d = g - g^p - ((r - (r^p - \pi^p - n^p)b$. A country could raise public spending temporarily, as long as its tax policy is such that no risk of default of the public debt arises. This rule leaves room for active economic policy in the short term. It would also allow countries with relatively higher real output growth and inflation (Southern or Central and Eastern European countries) to run a higher public deficit (consistent with higher debt depreciation due to higher growth and inflation). A country having to increase public investment transitorily would be able to finance it through borrowing. An advantage of this rule is also that countries have to take future prospects into consideration. For example, a country where pensions spending will increase in the future should start to raise taxes now.

This rule has one major weakness: it would be very difficult to implement in practice. How can the permanent level of public spending be calculated? A country may decide to run a certain level of deficit today, saying that public spending will be cut tomorrow. As is recognised in Buiter and Grafe (2003), the level of public debt is undetermined under the permanent balance rule. A country with nominal output rising by an annual 4%, with an interest rate of 6% and a permanent level of public spending of 40% of GDP may chose to fulfil the rule with a public debt of 0% of GDP (i.e. with a balanced budget and a tax rate of 40% of GDP), or with a 50% of GDP debt (i.e. with a 2% of GDP government borrowing and a tax rate of 41%), or with a debt of 100% of GDP (a 4% of GDP deficit and a tax rate of 42%). The rule does not say how fiscal policy should react to a demand shock. Besides, if public spending in year t benefits mostly the generation of year t, it is difficult to see why public spending should be paid by former generations. If the rises in old-age pensions spending benefit generations who will live longer, they cannot justify a rise in contributions paid by former generations. Buiter and Grafe raise the relevant issue of the intergenerational equity of public spending, but this cannot be ensured by an automatic rule. Each category of spending is specific. Last, and this is recognised by the authors, the rule sets an optimal fiscal rule at the national level. But it does not aim at defining surveillance criteria or a fiscal policy co-ordination strategy in EMU.

6.5. Quality of public finances

Several economists, like Buti and Giudice (2002), propose that the Pact takes the quality of public spending into account. Thus a country would be entitled to a higher deficit if domestic public investment is high, if it embarks on restructuring its public finances or if it undertakes tax cuts programmes. Conversely, countries would be blamed if they cut government borrowing through tax rises instead of lower public spending. This proposal introduces a new arbitrary. Should European authorities be entitled to reward countries that way? In our view, each country should remain responsible of the control of the quality of its fiscal policy.

6.6. A public expenditure rule

Brunila (2002), among others, proposed to add a complementary rule setting limits to public expenditure (excluding interest payments and unemployment allowances). This type of rule would be easy to implement and to control since the level of public spending is more easily controlled by governments than tax receipts. Members States would set a target for the medium-run growth of public expenditure and let receipts fluctuate with the economic cycle. This is the policy the French government had decided to run at the end of the 1990s. Countries with excessive structural government borrowing would have to cut the share of public spending in GDP. This proposal is in line with the Commission's view, according to which Members States should cut public expenses instead of increasing the fiscal burden.

This proposal suffers from two weaknesses. First, automatic stabilisers are allowed to work, but discretionary polices are not, which has no economic justification. Second, the appropriate level of public expenditure should be decided at the national level at the present stage of European integration. It is a social choice which should not become a macroeconomic one. No constraint should prevent a country from raising domestic public spending – pensions, health or unemployment – as long as it is financed by taxation.

6.7. Fiscal Policy Committees

Wyplosz (2002) proposes to establish a fiscal policy committee of independent experts in each Member State. This Committee would be given the mandate of ensuring debt sustainability. Hence his task would be the regulation of budgetary policy. The Committee would set the level of government borrowing, while public spending and receipts would remain under the control of national governments and parliaments. After the ECB's independence, this is a new step towards leaving economic policy entirely under the responsibility of a technocracy. The Committee would have to care for long-run public debt sustainability, while the objective of output stabilisation will come in second. Unfortunately, the author has difficulty in defining debt sustainability. Two possible definitions are given: balanced budget over the economic cycle (which means a public debt of 0% of GDP in the long run), stabilisation of the debt to GDP ratio in the medium run (i.e. excluding cyclical effects), but the author reckons that it is impossible to set an optimal level for this ratio. The author does not discuss the feasibility of his proposal. Changing economic circumstances lead observed budgets to differ from planned budgets. The Committee would have to control government policies in permanence and possibly ask for changes in taxation. Would this be acceptable for national governments? In an economic downturn, what would be the Committee's trade-off between the objectives of output stabilisation and debt stabilisation? More fundamentally, should macroeconomic strategy be decided without democratic debate?

6.8. An economic policy charter

Jacquet and Pisani-Ferry (2000) made several proposals. The most original was to ask European authorities (Commission, Council and ECB) to set up a group of experts in charge of elaborating an economic policy charter. This document would settle the way economic (monetary and fiscal) policies should react in response to any economic shock (supply or demand shock, asymmetric or symmetric). Debates, such as the appropriateness of fiscal deficits in bad times, would disappear. The second proposal was to improve the transparency of economic and monetary policies: the ECB would be asked to abandon the M3 growth pillar and to set more precisely its inflation target. Countries would have to state clearly their short-term and medium-term fiscal strategy. The third proposal was to give the Eurogroup the responsibility of piloting the euro area economic policy, the decisions being possibly made by qualified majority. We have already seen the problems this would raise: the fundamental issue is whether budgetary polices should be co-ordinated or decided at the European level. In the first case, the Eurogroup cannot impose a certain fiscal policy on a Member State. The fourth proposal would be to improve the interaction of national and European processes regarding the elaboration of budgets, the BEPGs and the stability programmes. This would significantly increase the influence of European processes on national budgetary procedures and would raise difficult questions in terms of organisation and agenda.

6.9. The surveillance of public debts

Pisani-Ferry (2002) proposed that fiscal discipline should focus on debts rather than deficits, since it is an excessively high level of debt that may threaten the sustainability of public finances. The author proposes to take off-balance sheet liabilities (like old-age pensions) into account in the assessment of public debt levels. But in that case, anticipated receipts should be considered too, like social contributions. The proposal opens the door to a never-ending process. But it has to be recognised that the notion of 'public debt' is basically ambiguous. The Treaty refers to an accounting definition of gross public debt, which has no economic meaning: public debt can be reduced through privatisation receipts, leasing operations on public infrastructures, etc.

Pisani-Ferry suggests that countries may opt for a 'debt sustainability pact'. Countries could on a voluntary basis make public their off-balance debts; they would commit themselves to maintaining the debt to GDP ratio below 50% and to a target for the debt to GDP ratio over a

5 year horizon. Hence, they would not be subject to the excessive deficit procedure based on public deficits. The proposal suffers several weaknesses. The notion of 'off-balance debts' is unclear. The 50% figure is arbitrary and has the only characteristic of being below 60%. The proposal does not give a definition of the medium-term commitment: debt reduction or stabilisation? It does not mention how cyclical effects should be considered: the debt to GDP ratio deteriorates automatically in times of subdued activity because of rising government borrowing and of output stagnation. How should this be taken into account (see box 4)? This proposal deals with the negative spill-over effects of debt but its does not take into account the negative spill-over effects of inflation. A country with a low level of debt would be able to undertake an excessively expansionary and inflationary fiscal policy. Partner countries and the Commission would be unable to stop it before the debt ratio reaches 50% of GDP. Piloting fiscal policies with a debt rule is even less precise than with a deficit rule.

The idea of a sustainability Pact can also be found is Cœuré and Pisani-Ferry (2003). Each country would have to publish a 'comprehensive balance sheet of the public sector' (including off-balance elements), to prepare long-term plans providing evidence of future public sustainability, and to infer from these plans an operational target for the gross debt to GDP ratio. This target would depend on public sector assets and liabilities. A fiscal rule would then be announced by the government, which would ensure that the actual debt to GDP ratio will converge to the objective. This rule would have to be approved by the Commission and the Council, which would be responsible for its monitoring. It is uneasy to understand how this complicated procedure based on a large number of long-term assumptions may be implemented in practice. It is also difficult to understand why euro area countries should be subject to such a procedure, contrary to the US, the UK, Japan, Russia… It is difficult to see why there is a specific risk for debt sustainability in the euro area. The proposed procedure would put excessive pressure on future public health and old-age pensions spending while these types of spending can be financed provided that citizens are willing to pay for them. Besides, the proposal does not say a word on short-term fiscal policies. Would a country be entitled to higher deficits in 2003 if it has announced the implementation of a reform due to lower public pensions after 2010?

Pisani-Ferry (2002) also suggested that a macroeconomic dialogue should take place in Europe between the ECB, the Member States and the Commission on the notion of equilibrium rate of unemployment and on the ways to lower it. The author suggested that stabilisation policies should be considered apart from structural policies. Stabilisation policies would be responsible for maintaining demand at the level of the equilibrium rate of unemployment, while structural policies would aim at reducing the equilibrium rate of unemployment. Given the uncertainties surrounding the measures of this equilibrium rate, it is difficult to see how the debate could take place. On the one hand, the equilibrium rate of unemployment probably depends on past observed unemployment, hence on short-term economic policy: in a country where output growth is subdued, employees and employers are not tempted to develop skills through training programmes, unemployed people become unemployable, rising social benefits entail higher labour taxation, the equilibrium rate of unemployment rises. On the other hand, it is impossible to link seriously a given labour market reform with the equilibrium rate of unemployment. The proposal could contribute to put pressure on unions so that they accept further liberalisation of labour markets against promises of more expansionary macroeconomic policies.

6.10. Lowering public debt

Gros (2003) thinks that the Pact should put emphasis on debt levels rather than deficits, because he considers public finance sustainability to be the major risk. He proposes to add a new element to the excessive deficit procedure, by setting a minimal speed for debt reduction in countries where debt levels stand largely above the 60% of GDP threshold. In practice, these countries would be requested to cut the differential between their debt ratio and the reference ratio by 5% each year. Thus a country with a 100% of GDP debt would have to bring it down the following year to 100 – 0.05 (100 – 60) = 98% of GDP.

This proposal does not address the issue of the compatibility between *a priori* set targets for public finance and the necessity to reach short-term and medium-term macroeconomic equilibrium. Let b, the level of public debt as a share of GDP, g: nominal output growth. The proposed rule requires that the deficit, d is such that $d < 3\% + b_{-1}(g - 5\%)$. With an annual nominal output growth higher than 5%, the rule is less strict than the 3% of GDP reference. In economic slowdowns, the rule will impose weaker and weaker deficits as output growth decelerates. The rule is therefore pro-cyclical. In the medium term, the rule will be less strict than the close-to-balance or in surplus target for deficits: a country having a 100% of GDP debt ratio will be allowed to run a deficit of 1% of GDP under the assumption of a 3% of GDP nominal growth.

6.11. New rules

Calmfors *et al.* (2003) stress out the need for different and discretionary national fiscal policies in a monetary union, these policies having an impact on activity. However, the authors think that such policies are uneasy to implement, in particular because of long decisions lags and also because there is a risk of irreversibility of decisions and of expansionary bias. The authors point out the rise in public debts in the European Union from 1980 to 1996, but they do not consider the role of monetary policy in this rise (Creel and Sterdyniak, 1995). Thus the authors think the EMU should provide an opportunity to strengthen fiscal discipline.

As the authors believe that the major risk is debt unsustainability, they suggest that the limit for deficits should depend on public debt levels. Thus, the limit would be 0.5% of GDP for countries where debt stands above 105% of GDP, 1% for countries where debt stands around 100% of GDP, 3% for countries where debt is close to 60%, 4% for countries where debt is 40%, etc. This would be an incentive for Member States to reduce public debt so as to get more cyclical room for manoeuvre. The proposal raises constraints on highly indebted countries: Italy, Belgium and Greece. But in the case of the first two countries, the opportunity of the constraint can be questioned since the level of public debt has a counterpart in a high households' saving ratio. The constraint comes as an additional similar constraint of the objective of a medium run budget in balance, which implies a continuing decrease in the public debt to GDP ratio. The proposal follows a weird logic according to which a country having no control on its domestic interest rate may decide arbitrarily to determine the domestic debt level. Let us consider a country where there is an initial debt to GDP ratio of 60%. In order to cut this level to 40%, the government may decide to run a restrictive fiscal policy of 2% of GDP during 10 years. This policy will not lead to a significant cut in the ECB's interest rate but it will almost certainly durably depress activity, for a dubious usefulness.

The authors also suggest that the excessive deficit procedure be under the authority of the European court of justice. The 3% of GDP limit would be legally binding. Is this advisable, knowing that there is no economic rationale for this limit, and that a country may well breach it without generating negative externalities?

Last the authors propose that Member States be obliged to make their national fiscal policy procedures conform to a common framework, which would guarantee that 'good decisions' are made at the national level, independently of the European level. They design two possible schemes:

— Each Member State would have to adopt a "law on fiscal policy", which would set precisely the objectives for public deficits, debts and stabilisation. This law would indicate the instruments to be used transitorily for cyclical purposes. This law would guarantee *ex ante* national budgetary policies in conformity with European requirements. Is it realistic to maintain *a priori* fiscal policy in a very constraining framework, especially when fiscal policy is the only national policy tool available? It is an illusion to believe that a law voted at some point will be a commitment for a future government, elected with another majority and facing another position of the economic cycle, some years later.

— Each country would have to implement a 'fiscal policy committee', as advocated by Wyplosz (2002). This committee would be in charge of maintaining public debt sustainability and output stabilisation, either by setting the level of government balance, or by setting itself the level of some taxes. This proposal shares the view of those who think that democratically elected governments, thus the People, should be deprived of their authority, and that this responsibility should be given to a group of experts or technocrats. This is a dangerous by-product of European construction.

6.12. An aggregate balance target

Dominique Strauss-Kahn had proposed at the informal Ecofin Council in Dresden in April 1999 that the Eurogroup should first discuss and set the desired policy for the euro area, before setting the global objective for the area. The global target would be broken down into national targets in a second step.

The proposal did not say if the ECB would participate in the co-ordination process. If the ECB and Members States agreed on explicit co-ordination to control inflation and activity, then the outcome could be similar to the ideal example described in box 3. Interest rates would assure a satisfying level of aggregate activity; government balances would assure a satisfying level of national activity. If the ECB did not participate in the co-ordination process and if co-ordination targeted only government balances, then no improvement could be expected as compared to the existing situation. It is difficult to understand how the aggregate public deficit target would be defined and 'shared' between Member States.

6.13. Some internal adjustment only

Buti, Eijffinger and Franco (2003) think that the mechanisms of the Pact work relatively well. They propose only limited changes to achieve 'stronger discipline and higher flexibility'. They have five suggestions:

— *Country-by-country medium-term targets.* Countries with a relatively low level of (explicit and implicit) public debt would be allowed to have a medium-term deficit target in the range of 1 to 1.5% of GDP. Thus deficits would not breach easily the 3% limit, which remains the absolute reference, in times of economic slowdown. With a medium run deficit target of 1.5% of GDP, the debt to GDP ratio could remain close from 30% (with a 5% nominal GDP growth). With this proposal, a more realistic long-run debt objective becomes possible. In practice, such a softening of the rules would not benefit countries like France, Germany, or Italy with large public pensions systems (and a large implicit debt). If these counties want more flexibility in the conduct of fiscal policy, they will have first to cut the size of their pay-as-you-go retirement systems. This proposal is designed to facilitate the UK membership in the euro area.

— *Improving transparency.* The authors ask countries, or Eurostat, to publish real 'structural balances', i.e. corrected from exceptional and one-off measures (UMTS licences, leasing or securitisation operations, one-off taxes...). We can only agree with them.

— *Tackling 'misbehaviour' in good times.* The authors want to prevent countries from stopping fiscal consolidation efforts during high-growth periods, as was the case in 1998-2000. They suggest that early-warning procedures could be launched against countries which have not sufficiently reduced their structural deficit (even if they have cut their public deficit). But this procedure requires an agreement on the level of potential output and on the optimal level of deficit.

— *A 'Rainy-day fund'.* Countries would put some money in a specific fund in good times, and would withdraw these resources in bad times. This proposal looks somehow awkward because such purely financial operations have no impact on government borrowing in national accounts. There is no difference between using receipts for debt reduction and allocating them to a fund. Thus the authors suggest a change in national accounts methodology, so that transfers to the fund would raise public deficits and that withdrawals would reduce public deficits. For instance, a government running a surplus of 1% of GDP in 2000 could transfer it to the fund. If there was a public deficit of 3.5% of GDP in 2002, the government would have the possibility to bring it down to 2.5% with a 1% withdrawal from the fund. But national accounts methodology must be based on economic logic and not on political arrangements. As the European Commission (2002*c*) writes, 'Eurostat acts in accordance with the principles of [...] scientific independence'. Policy makers have to improve economic policy rules but they should not be allowed to change the instrument of measure.

— *A non-partisan implementation of the rules.* The authors suggest that the Commission should be given more power to deliver early-warnings, to determine the existence of excessive deficits, to decide of sanctions. Such a reform seems inappropriate to us, as long as fiscal rules are not better designed. A soft implementation of the Pact remains necessary.

7. Our proposal

The European economic policy framework is a matter of political choice: what decisions should (or not) be democratically debated? What powers should be in national or community hands? It is also a technical choice: monetary and fiscal policies must be compatible.

It could be imagined to establish a democratically elected economic government of Europe, which would be responsible for monetary and budgetary decisions. But this is currently a utopia. Democratic debate has remained at the national level and business cycles as well as institutions still differ from one country to another. It is difficult to imagine how an economic government of Europe could address all national issues.

The conduct of monetary and fiscal policies could be given to the European Commission. But the Commission has no democratic legitimacy. National governments would loose all degrees of freedom in the conduct of national economic policies, would have to follow strictly the strategy of the Commission and would ask its permission to undertake any measure. It would be the triumph of the Community, Technocratic and Liberal ideology.

The government could be left under the responsibility of an 'Ecofin Council of the euro area', but this would mean giving excessive power to the ministers for economics and finance, at the expense the other ministers and of national parliaments. Any government intending to introduce a new measure would have to get an authorisation from its partners first. It is difficult to imagine that the French government elected in 1997 would have asked for its partners' approval before introducing the 35-hour working week for instance, or that the German government would have submitted its fiscal reform to its partners' approval. Would this group of ministers be entitled to decide on the reforms of the pensions systems to be implemented in the different Member States?

Given the current level of European political integration, countries and governments must keep their prerogative on national fiscal policy, as long as it does not affect the macroeconomic position of the area. The surveillance of economic policies should consist in avoiding that any national fiscal policy negatively affects the rest of the area. That is why binding rules should bear directly on externalities.[13]

Thus, the rule should be that each country may be allowed to define national fiscal policy, as long as it does not affect the macroeconomic equilibrium of the area, in other words as long as domestic inflation stays in line with the inflation target of the area. For instance, if there was an inflation target of between 1.5% and 3.5% in the area, one could imagine that Northern countries would could be given a target within 1 and 3%, while 'Southern' countries (more precisely the countries on a catching-up process) would have a target of between 2 and 4%. In such a system, a country hit by a negative demand shock would be able to counterbalance it through temporary fiscal loosening. Conversely, a country hit by a supply shock (inflationary pressures) would have to tighten fiscal policy.

The Commission and the Ecofin Council of the euro area would have the responsibility to check that inflation remains at the level set in each country, and possibly to accept some deviations and adjustment periods in the event of specific or common shocks. The European authorities could also have the responsibility to check that domestic public debt variations do not put the sustainability of public finances at risk, or to check that no country has an excessively large current account deficit relatively to the current account balance of the area. The crucial point is that surveillance should bear only on issues potentially leading to negative externalities between countries in the area.

However, this organisation does not define the respective roles of monetary policy and fiscal policies considered as a whole. A satisfying level of global demand, compatible with the desired inflation-production trade-off may be obtained either through a combination of high interest rates and public deficits or a combination of low interest rates and public deficits (see box 5). The second combination will induce higher private investment and therefore will be

[13] Otherwise it opens the door to supranational paternalism, as pointed out in Buiter (2003): 'we know what is good for you and you will do it, even though your failure to do what is good for you would have no detrimental impact on the other members of the club'.

preferable in terms of medium run output growth.

Box 5. Compatibility between monetary policy and fiscal policies

Let us consider the model presented in boxes 1 and 2. In order to reach the inflation target, it is necessary that: $\Sigma g_i - n\sigma r = -\Sigma \pi_i^0 / \alpha - \Sigma d_i$ at the area level. This is compatible with a situation of high interest rates and high public deficits or with a situation of low interest rates and low public deficits. Therefore, a process where monetary policy and fiscal policies are fully compatible has to be found. The optimal medium-run strategy is that the central bank sets an interest rate target, r^{obj}, equal to nominal output growth, i.e. the lowest rate compatible with economic efficiency. Fiscal policies would be responsible for the respect of the inflation target. Each country would have to target the following level of production: $y_i = -\pi_i^0 / \alpha$, and consequently their public deficit would be $g_i = -d_i - \pi_i^0 / \alpha + \sigma r^{obj}$.

The compatibility between monetary policy and fiscal policies has to be planned. In our view, the best rule is the following: monetary and fiscal policies should set a common medium-term objective aiming at the convergence of real interest rates with output growth, meaning the lower interest rate consistent with economic efficiency. If the long-term real interest rate is higher than output growth, it means that investment is too weak: monetary policy should cut interest rates and should be accompanied by restrictive fiscal policies in the countries where the interest rates cuts would raise excessively inflation. But as long as the real interest rate equals output growth, a country cannot be blamed for running some public deficit if this is necessary to support domestic activity. National fiscal policies should be in charge of managing the inflation-production trade-off in each country, under the constraint of a medium-run inflation, while monetary policy should target the interest rate.

Medium-term ‘close-to-balance or in surplus’ budgetary positions are not a major issue Europe should address today, in the context of highly volatile stock markets and of uncertain short-term economic prospects. The US government has undertaken a discretionary fiscal policy in the recent slowdown, while euro area governments hesitate to let automatic stabilisers work. The ECB is very careful not to seem to support ‘budget deviations’ which does not help the implementation of a credible policy mix in the euro area. The current weakness of activity illustrates the need for economic policy to be less ‘automatically’ managed in the euro area. An open process of co-ordination is needed.

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