STABILITY PACT REFORM: A LOOK AT "WHAT MIGHT HAVE BEEN"[1]

Marc Coleman

1. Introduction

There is a French phrase "l'Esprit d'Escaliers" (literally "the spirit of the stairs") that describes a sentiment that is sometimes felt when climbing stairs to bed having completed a hard day's work. It conveys the feeling that the day's work could and should have been done better.

In March of this year, the European Council endorsed proposals from ECOFIN to reform the *Stability and Growth Pact,* ending a political debate that had surrounded the Pact arising from the suspension of the Excessive Deficit Procedure against France and Germany in November 2003. But although the political debate is over, an analysis of the decisions taken is warranted, particularly given the gravity of Europe's fiscal situation.

As we "ascend the stairs", it is impossible not to feel that the Pact could have been reformed in a much better way; as shown in Table 1 below, the EU's public finances continue to deteriorate.

But it is never enough to criticise. If you complain about the dark, then at least light a candle. In this spirit, the paper outlines how a reform of the Pact could have been constructive, credible and consensual. Two issues have arisen since the Pact's creation in 1996 which together provide a credible reason for reform, i.e. one not open to the charge that the Pact was reformed by politicians for political reasons (a charge that haunts the present reform).

First, EU enlargement has made Europe a more fiscally heterogeneous place. Compared to other member states, new member states have higher fiscal deficit ratios, but also lower government debt ratios and stronger trend growth and thus a higher

[1]This paper is an updated version of the paper "Reforming the Pact Without Frightening the Horses" delivered at the annual Dublin Economics Workshop in Kenmare, October 2004. The central feature of it derives from research by the Author and by Christophe Kamps as part of the Advanced Studies Programme at the Institute of World Economics in Kiel.

capacity to absorb those higher deficits. Those higher deficits are broadly proportionate to higher levels of capital expenditure, compared to other member states. As developing counties with higher marginal productivity of capital, this is a new fact that should have prompted reform of the Pact regardless of the events of November 2003. Second, the attention on the fiscal challenge of ageing in Europe has intensified and strengthened the case for shifting the emphasis of the Pact towards fiscal sustainability.

This paper aims to show how a clear, credible and consistent reform of the Pact could have arisen from these two considerations. It also identifies improvements that needed to be made in the Pact's institutional design. Section 2 of the paper outlines the key features of the Pact that are relevant to its possible reform. Section 3 gives an account of the crisis in the Pact in November 2003, the build up to it and the various proposals to reform that preceded this crisis. Section 4 contains the central feature of the paper. It sketches the rationale and outline of an "ideal" reform of the Pact, a reform that could have dealt with the aforementioned issues by relaxing its provisions in relation to medium-term fiscal balances, toughened its provisions in relation to long-term debt and improved some key features of implementation. Section 5 concludes.

2. Key Features of the Stability and Growth Pact

Three dimensions of the Pact are to be considered in the context of reform. The first is its substantive purpose; i.e. the fiscal rules it stipulates. The second is institutional design; i.e. the mechanisms by which it aimed to enforce those rules. The third relates to a relevant statistical question.

The substantive rules of the Pact are as follows:

1. Member States must avoid incurring a General Government Deficit in excess of 3.0 per cent of GDP unless this results from either an "unusual event outside the control of the Member State concerned" or from a "severe economic downturn". The first caveat is not defined in the Pact while the second is defined as an annual fall in real GDP of at least 2 percentage points.[2]
2. Member States must maintain budget balances that when adjusted for the effects of the economic cycle are "Close to Balance or in Surplus" and should avoid fiscal policies which are pro-cyclical – aiming in other words for surpluses in good times and deficits safely within the 3.0 per cent limit in bad times.[3]
3. Member States must maintain General Government Debt levels of below 60 per cent of GDP. However, this aspect

[2] If further supportive evidence is available, a 0.75 percentage point or greater decline in real GDP may also be regarded as a severe downturn.

[3] The "Close to Balance or in Surplus" criteria for fiscal balances in measured by the Commission with reference to a specified and agreed method for adjusting "headline" General Government Balances for the effects of the economic cycle. For a discussion on the methodology see Denis, McMorrow and Roeger (2002).

> of the Pact was not implemented and the equivalent stipulation in the Treaty that countries permitted to join the Euro Area should have debt levels below this threshold did not prevent Belgium, Italy or Greece from successfully joining the euro with debt levels that were significantly higher.

In terms of its institutional design, the Pact might be seen as having two arms, one preventative and one dissuasive.

The first, preventative "arm" is constituted by Council regulation 1466/97. This stipulates that Member States will provide Stability Programmes once in EMU on an annual basis, that these will contain medium-term budgetary targets[4] and that these programmes and their implementation will be regularly monitored by the Council and Commission. More importantly, any divergence from sound medium-term budgetary intentions contained in the programmes, or any failure to implement budgetary plans in an acceptable manner will be dealt with by an early warning system.

The second, dissuasive arm deals with the situation where the preventative arm has failed. It is constituted by Council regulation 1467/97 and is based on article 104 of the Treaty. This regulation defines the "Excessive Deficit Procedure" – a procedure which may lead to the imposition of sanctions.

A key issue is that the discretion of imposing sanction rests ultimately with the Council. The German Finance Minister at the time of the Pact's negotiation and conclusion, Theo Waigel, proposed the creation of an independent "Stability Council" to implement the Pact. The Commission raised the difficulty that such an approach would pose from the point of view of infringing the sovereignty of Member States. For this reason, the power of implementing the Pact was left in the hands of the Council.

Finally, the statistical interpretation of the Pact deserves brief reference here before being dealt with in Section 4. Arguments have been made for a looser interpretation of the definition of the General Government Deficit. Giavazzi and Blanchard (2003) note that Article 104.3 of the Treaty would in theory permit an interpretation of the Pact to exclude net investment expenditures by reform of Council regulation 1467/97. This issue is relevant to considering the pressures in new Member States to invest in public capital.

3. From Crisis to Reform

Crisis in the Pact and Fiscal Deterioration

In spite of wide-ranging academic debate surrounding these aspects of the Pact's design, the political consensus behind it continued to be strong during the years immediately before and after the introduction of the euro.

[4]These targets must be consistent with the "Close to Balance or in Surplus" criteria of the Pact.

The year 2003 began with some prospect of a positive reform process, as commissioned by the outgoing European Commission President, Romano Prodi, the "Sapir Report"[5] made several recommendations for reforming the Pact. The year ended with the institutional credibility of the Pact seriously in question as France and Germany successfully lobbied a majority of the Council to suspend the Excessive Deficit Procedure against them.

The table in Annex I shows how this transition occurred. The crisis in the Pact had its origins in the failure to give an early warning to Germany and Portugal in early 2002. In Portugal's case the deficit warning turned out to be accurate and in November 2002 the Council accepted a Commission recommendation to the effect that Portugal had an excessive deficit.

However, following this implementation against Portugal (and a real commitment to severe fiscal correction by that country), France and Germany lobbied successfully in November 2003 to have the Pact's Excessive Deficit Procedure suspended in relation to their budgetary positions.

Since then and according to the Spring 2004 forecasts of the European Commission,[6] six countries have breached the deficit in 2004 and four are projected to do so in 2005, with Germany and Greece coming close to breach. Thus adherence to the Pact is clearly declining.

Table 1: Actual and Cyclically Adjusted Balances

	Actual Budgetary Balances				Cyclically Adjusted Budgetary Balances			
	2002	**2003**	**2004**	**2005**	**2002**	**2003**	**2004**	**2005**
Belgium	0.1	0.2	-0.5	-0.7	0.1	0.7	0.0	-0.5
Germany	-3.5	**-3.9**	**-3.6**	**-2.8**	-3.5	-3.2	-2.9	-2.3
Greece	-1.4	**-3.2**	**-3.2**	**-2.8**	-1.7	-3.6	-4.1	-3.8
Spain	0.0	0.3	0.4	0.6	-0.2	0.4	0.6	0.7
France	-3.2	**-4.1**	**-3.7**	**-3.6**	-3.8	-3.9	-3.4	-3.3
Ireland	-0.2	0.2	-0.8	-1.0	-1.9	0.1	-0.3	-0.2
Italy	-2.3	-2.8	**-3.2**	**-4.0**	-2.2	-1.9	-2.6	-3.6
Luxembourg	2.7	-0.1	-2	-2.3	2.7	1.3	0.6	1.2
Netherlands	-1.9	**-3.2**	**-3.5**	**-3.3**	-2.6	-2	-1.7	-1.3
Austria	-0.2	-1.1	-1.1	-1.9	-0.3	-0.9	-0.9	-1.8
Portugal	-2.7	-2.8	**-3.4**	**-3.8**	-2.7	-1.8	-2.1	-2.6
Finland	4.3	2.3	2	2.1	3.7	2.3	2.1	2.2

Source: 2004 Public Finance Report of the European Commission.

[5] After its main author, Professor Andre Sapir, the then adviser to Mr. Prodi.

[6] These were the latest forecasts available at the time of writing. Subsequent forecasts do not fundamentally differ for the purposes of this paper.

Commission Reform Proposals

The "Sapir Report" published in 2003 argued that the "exceptional circumstances" defined in the Pact for exempting a Member State from sanctions in the case of a breach of the 3 per cent deficit limit be made more lenient. It also suggested that the GDP growth rate required for such an exemption be changed from a negative growth of 2.0 per cent[7] to a rate of zero growth and that cyclically adjusted deficits of up to 1.5 per cent of GDP be permitted for counties with debt to GDP ratios that were below 40 per cent. The Sapir Report also called for greater macroeconomic co-ordination in Europe. It called for a greater contribution to be made to growth by fiscal policy. The first two proposals are revisited in the final section of this paper.

In the summer of 2004 the Commission's Public Finance Report proposed a further tentative outline of reform. It proposed to redefine the medium-term objectives of close to balance or in surplus to allow low debt countries more flexibility and to place more emphasis on debt and sustainability in the surveillance of budgetary positions and to initiate Excessive Deficit Procedures in case of inappropriate debt developments.

It also sought to cater for protracted slowdowns by redefining "exceptional circumstances" more loosely and to allow for country specific elements in the enforcement of the correction of excessive deficits, including setting more flexible deadlines. On the institutional side it called for early warnings and recommendations to be used more actively.

ECOFIN Proposals

The ECOFIN proposals, endorsed by the European Council in March 2005, contain a reference to the need for economic and budgetary policies to "… set the right priority towards…the strengthening of private investment and consumption in phases of weak economic growth". As well as improving the economic rationale of the Pact, these reforms also aim to improve national "ownership" of fiscal policy.

Furthermore, in a watering down of the Excessive Deficit Procedure, its rationale is stated as being "assisting rather than punishing" member states and the incentives for Member States to adhere to the Pact are cited as "surveillance", "peer pressure" and "peer support". The reforms also reaffirm the power of the Council to reiterate sanctions – a key institutional weakness of the Pact.

Some references are made to ensure more budgetary discipline in good times and on the other hand allow more leniency in times

[7] It should be noted at the outset that the operation of the stability and growth pact allows for a 'grey area' for a GDP decline of between 0.75 and 2.0 per cent in which consideration can be given to defining economic circumstances as sufficiently exceptional to permit an excessive deficit.

when economic growth is below trend. The need to give sufficient attention to debt and sustainability is also recognised.

However, the proposals request that in future the Commission is requested to include in its reports to the Council a variety of factors in assessing the budgetary situation of a Member State, including whether the deficit exceeds the level of investment expenditure and the existence of "other relevant factors" that might pertain to the budgetary balance. Also noteworthy are the extensions of the deadlines stipulated for the operation of the Excessive Deficit Procedures (by a total of six months) as well as for the implementation of fiscal correction in case of breach (by one year).

What is clear is that the evolution of reform proposals from those advanced by the Sapir Report to those endorsed by the Council in Spring 2005 has followed a trend of declining connection to fundamental economic rationale and increasing inclusion of exceptional provisions.

But the need in relation to Pact reform was not only to improve its economic design, but more importantly to restore its credibility as a rule that would be respected and implemented. This required basing reforms on a strong, durable and thorough economic rationale. What might this rationale have looked like?

4. EU Enlargement and Reform: A Look at What Might Have Been

Economic Rationale for Reform

The main economic rationale for reforming the Pact can be illustrated by pointing to some basic differences between the ten acceding countries ("AC10") and other Member States ("EC15") contained in Table 2 and Table 3.

Table 2: Key Economic Indicators for EU15 and AC10 Countries in 2002

	GDP per Capita*	Real GDP growth
EU15	100.0	1.1
AC10	53.0	4.1

Source: European Commission, Spring 2004 forecasts and Summer Public Finance Report.
*Taking EU15 as = 100 in 2002.

Table 3: Key Fiscal Indicators for EU15 and AC10 Countries

	Deficit/GDP 2002	Debt/GDP 2002	Capital Expenditure/GDP 2002
EU15	-2.0	62.6	2.2
AC10	-4.0	37.6	3.7

Source:: European Commission, Spring 2004.

Five clear differences emerge:

1. Average GDP per capita in the AC10 group is about half of what it is in EU15 group.
2. Average real GDP growth is considerably higher in the AC10 group, compared to the EU15 group.
3. The average deficit in the AC10 group is about twice that of the EU15 group.

4. The average debt/GDP ratio in 2002 is over 60 per cent for the EU15 group but just under 40 per cent for the AC10 group.
5. The ratio of capital expenditure to GDP is 1.5 percentage points higher for the AC10 group compared to the EU15 group and this differential is comparable with the 2 percentage points differential in the relative sizes of deficits between the two groups.

Classic growth theory suggests that countries with lower GDP per capita grow faster and have a higher marginal productivity of capital. Both circumstances – *ceteris paribus* – justify higher rates of capital investment. Higher growth rates also permit higher sustainable deficits as the impact on the Debt/GDP ratio is offset by higher GDP growth.

By considering in turn two fundamental goals of the Pact – sustainability and stability – the implications of these facts for desirable reform become clearer:

Sustainability and the Debt and Deficit Limits

The Pact limits of 3 per cent and 60 per cent on the deficit and debt ratios, respectively, follow a basic mathematical logic. Assuming no monetary financing of debt, debt should be maintained at its existing level provided that the following condition holds:

Budget deficit = Debt level x. Trend Nominal Growth Rate.

Taking a debt level of 60 per cent of GDP as constituting long-term sustainability, the budget deficit should be 60 per cent of the trend nominal growth rate in order to prevent the debt ratio from growing. The figure below shows debt evolution under the assumption of "just-in-line" with the Pact – namely assuming a deficit of 3 per cent per annum run every year – for two different scenarios.

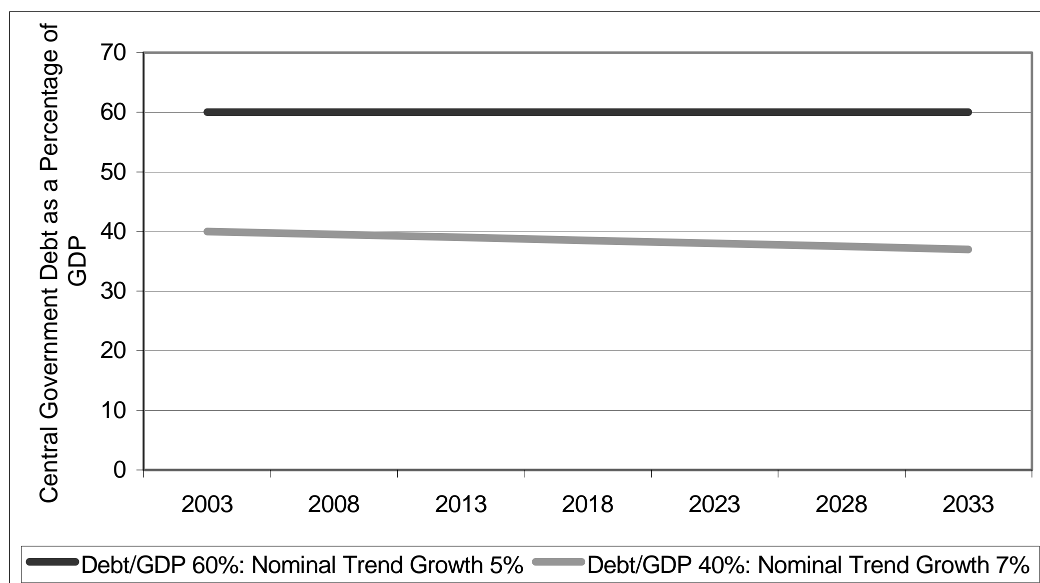
The first scenario is for a "traditional" EU member state, with nominal trend growth of 5 per cent.[8] The second is for a new member state with trend growth of 7 per cent and a lower starting debt ratio. Assuming both maintain a deficit of 3 per cent indefinitely the traditional EU member state maintains a stable debt ratio while the new member state's debt ratio declines secularly. This shows that the same fiscal rules have different implications for sustainability depending on trend growth and initial debt ratios.

As the ultimate rationale of the Pact is to protect the stability of the Euro, it is important at this juncture to consider that financial markets are more concerned about the sustainability of a country's debt situation than about any particular current deficit limit[9]. In an ECB paper, Afonso and Strauch (2004) examine the behaviour of interest rate swap spreads to major fiscal policy events during 2002

[9] Of course if the deficit is symptomatic of or symbolic of deeper debt problems the two may be regarded with concern by financial markets.

and estimate a reaction function for these spreads. They find that capital markets reacted rather weakly to emerging news about the deficits of Euro Area countries.

Figure 1: Debt Sustainability under SGP over a Thirty Year Period



Stability and the "Close to Balance or in Surplus" Rule

Turning to stability, the Pact aims to stabilise fiscal outcomes by encouraging the maintenance of medium-term fiscal balances around which cyclical conditions should move short-term nominal fiscal balances within a corridor of plus or minus 3 per cent of GDP.

The deficit should respond to the cycle according to the following simple relationship:

$$d_t = d_s + \beta(y_s - y_t)$$

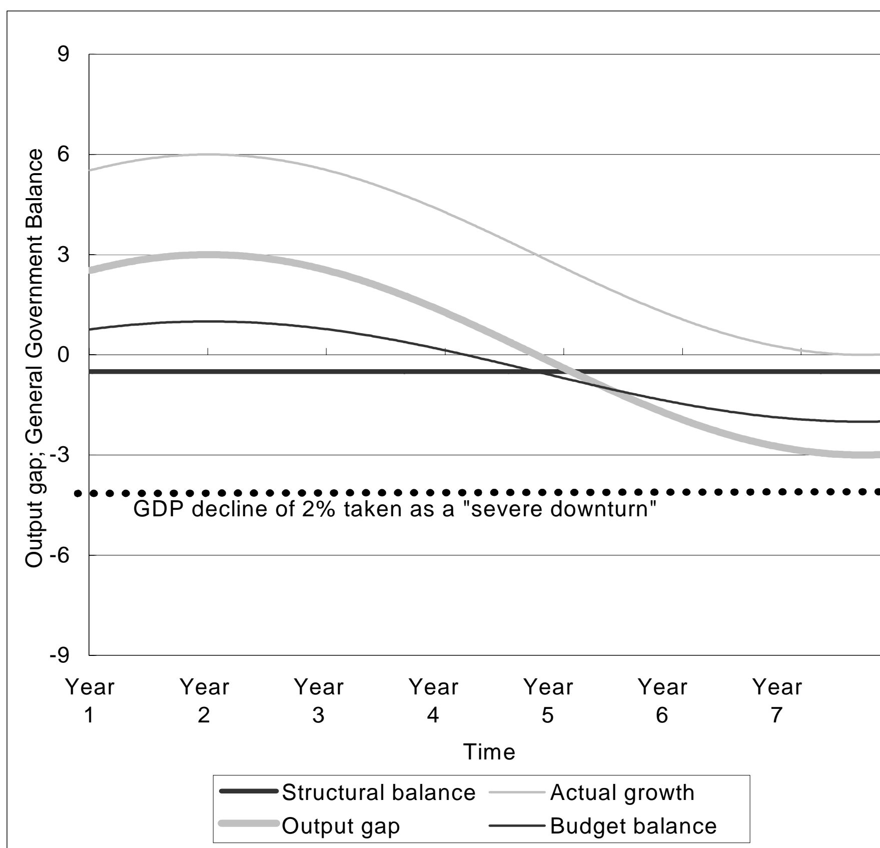
The deficit in time t equals the structural deficit plus the budgetary elasticity times the output gap.

The figure below shows a simple stylised process of fiscal breathing which illustrates how the *Stability and Growth Pact* is designed to function in an ideal state. The figure assumes that the economy operates according to the standard seven year "Burns Mitchell" cycle.

Trend growth is assumed to be 3.0 per cent and the output gap is assumed to fluctuate between plus and minus 3 per cent. The actual real GDP growth rate therefore fluctuates between 6 and 0 per cent.

Assuming a medium-term structural balance of -0.5 per cent[10] and a budgetary elasticity of 0.5,[11] the figure below shows how, in an idealised state of no discretionary intervention or non-cyclical macroeconomic or fiscal shocks, automatic stabilisers will ensure the smooth fluctuation of the budgetary balance between +1 and -2 percentage points.

Figure 2: The Operation of the Stability and Growth Pact



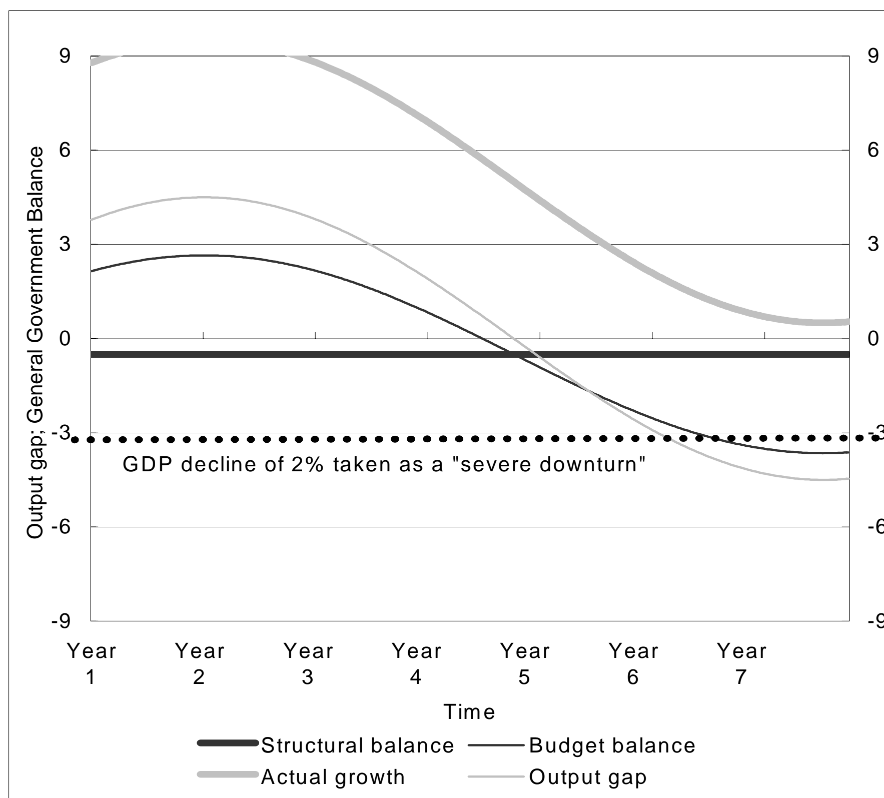
Note that under these idealised assumptions the budgetary balance is -2 percentage points when the GDP growth rate is 0 per cent. In this scenario a breach of the 3 per cent deficit rule would be consistent with a GDP decline of 2 per cent. This breach would be exempted under the terms of the Pact on the grounds of qualifying as a “severe economic downturn”.

[10] According to the European Commission (2001a) a margin of 0.5 per cent of GDP below strict balance can be allowed for when assessing compliance with the “Close to Balance or in Surplus” criteria.

[11] An elasticity of the budget balance with respect to the output gap of 0.5 percentage points is consistent with a wide range of evidence in relation to budgetary balances and output gaps in EU and OECD countries. See for example OECD (1997).

Now take a country with high trend growth, higher budgetary elasticities and a higher mean output gap. The figure below shows the evolution of the budgetary balance over the same seven year economic cycle, but for a stylised New Member State.

Figure 3: The Operation of the Stability and Growth Pact: The Case of a New Member State



The trend growth rate of real GDP is assumed to be 5 per cent, 2 percentage points higher than for a more mature European economy. The budgetary elasticity is assumed to be 0.7 percentage points and the output gap is amplified by a factor of 1.5 to reflect a relative dependence on the world economy and foreign direct investment.

The structural balance is assumed to be -0.5 percentage points as before and the economy of the idealised New Member State is assumed to be in step with the global economy in the same manner as assumed for the traditional case above (although the output gap is assumed to be slightly more volatile as mentioned above).

By contrasting the developments in the two figures for year seven, the irony of the situation is clear. The idealized "New Member State" has a higher growth rate than the traditional EU Member State at the same position in the economic cycle. This is as a result of higher trend GDP growth.

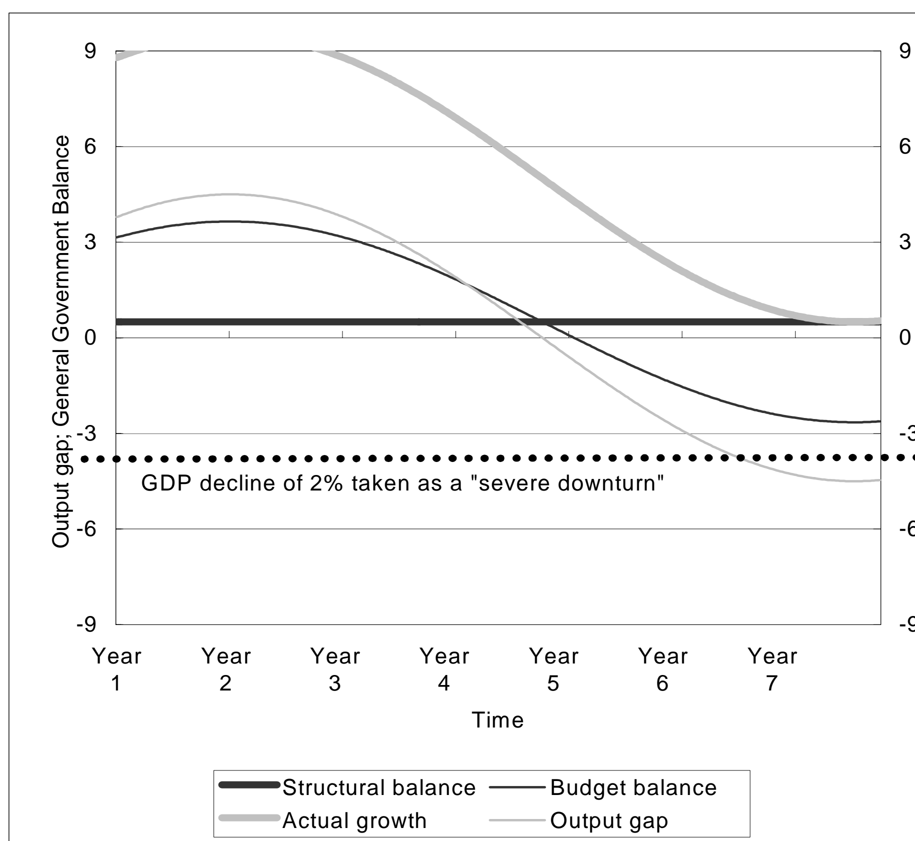
However, a higher budgetary elasticity and a slightly more volatile output gap means that this country could nonetheless breach the Pact, whereas a more mature economy would withstand

the worst point of the cycle with a deficit that was still safely removed from the 3 per cent limit.

The further irony is that due to its higher trend growth rate the idealised New Member State breaches the deficit limit at a rate of real GDP growth of around +1 per cent, well above the limits specified in the Pact.

The next figure shows that a tighter structural position – a *surplus* of 0.5 per cent – would be required to avert a breach of the Pact. Even with this tighter position, the budget balance scrapes quite near the 3 per cent limit, allowing little margin for a sudden shock.

Figure 4: The Operation of the Stability and Growth Pact: The Case of a New Member State with Structural Surplus



These figures illustrate an important anomaly in the Pact. A severe economic downturn is defined in terms of a rate of GDP growth. But the key anchor of the Pact is defined in terms of the output gap. This means that higher trend growth countries must suffer higher deterioration in terms of output gap before being able to avail of the -2 per cent “get-out” clause, compared to lower growth countries.

The relevance of this observation in relation to new member states is strengthened by considering the issue of their budgetary elasticities.

As calculated by van den Noord (2000) the mean value of the output gap in the 15 countries of the pre-enlargement EU is around 2.5 percentage points. The same source suggests that the assumption of a budgetary elasticity of around 0.5 percentage points is also a reasonable one for the same group of countries. However, the elasticities are higher in Denmark, Sweden and Norway, countries that may join EMU in future. This would imply the need for more demanding medium-term budgetary restrictions.

Elasticities for New Member States are unknown, they are possibly higher than other member states as in Scandinavian counties, given that the State remains relatively dominant as a legacy of decades of communism.

This would imply the need for more demanding medium-term balance criteria to avoid a breach of 3 per cent deficit limit.

Institutional Rationale for Reform

Two key institutional features need to be considered in the context of reform.

Firstly, the Excessive Deficit Procedure was lengthy and complex and this problem is worsened by recent reforms (see below). Beetsma (2002) has noted two resultant dangers: The first is the danger that punishment of a breach of the Pact occurs so long after the incidence of fiscal deterioration, that offending government may have been replaced by the opposition. This lowers the incentive for governments to adhere to the Pact and raises the possibility that the government being punished was in opposition at the time of the offence, as was in fact that case when Portugal was disciplined in 2003: The second is the scope created for haggling, bargaining and watering down of the Pact's provisions.

The second issue is the discretion of the Council in applying the Pact. Inman (1996) examined the effectiveness of balance budget rules in the U.S. and found that amongst the critical factors determining their success was the question of whether they were enforced by an independent authority. De Haan (2004) sees the lack of political independence in the Pact's implementation as its key institutional weakness. The potential for this weakness was spotted in 1995 by German Finance Minister Theo Waigel who proposed creating an independent "Stability Council" to monitor the Pact. The idea was objected to by the Commission.

The Parameters of Reform

The economic and institutional issues raised above are now projected onto four aspects of reform.

1. The definition of exceptional circumstances
2. The debt threshold
3. The close to balance or in surplus provision
4. Sound institutional workings

Parameter 1: Redefining Exceptional Circumstances

The original Pact permitted an exception from punishment for deficit breach in two ways.

First, it defined an "… unusual events outside the control of the Member State concerned and which has a major impact on the financial position of a Member State".

Second it defined a "severe economic downturn", constituting an annual fall of at least 2 percentage points of GDP. A fall of greater than 0.75 percentage points of GDP may also be considered as constituting a severe economic downturn.

In Section 1 the need for simplicity and credibility in fiscal rules was observed. On this basis the provision for "unusual events outside the control" of the Member State should have been abolished or curtailed. In fact it has now been strengthened.

Third and in the other direction, the criteria of requiring GDP to fall by 2 percentage points constituted a highly extreme definition of exceptional circumstances. Such declines are seen usually only in wartime. We might note also that Portugal and Germany would, under such a rule change, have been able to legitimately escape censure for breaching the 3 per cent deficit rule in 2002. France would still have been culpable, but would have been excused in 2003. The excessive strictness of the Pact in relation to the definition of a severe economic downturn might therefore be seen to have been one of the causes of the Pact's problems – the other being the role of the Council in implementing it.

Parameter 2: Complementary Debt Thresholds

Debt criteria have never been subject to the full operation of the Excessive Deficit Procedure. Yet concerns about population ageing mount and several member states have debt levels well in excess of the Pact's threshold of 60 per cent of GDP. New member states, however, have significantly lower debt levels.

By ignoring debt, the Excessive Deficit Procedure thus punishes the higher deficits of low debt acceding countries (which at least have some theoretical justification) while only acting against high debt countries if their deficits exceed 3 per cent of GDP. Arguably the Pact must be more discerning in this regard. This leads neatly to the next parameter to be discussed.

Parameter 3: Close to Balance or in Surplus

As noted above, new member states, have at least a theoretical case for maintaining higher levels of public investment expenditure. In this context the continuation post-enlargement of an indiscriminate application of the medium-term balance requirement appears questionable. Blanchard and Giavazzi (2003) have pointed out that this aspect of the Pact could be amended by a Council Resolution to exclude capital expenditure from the calculation of the General Government Balance. Milesi-Ferreti (1998) has noted the dangers in such an approach.

A better approach – and one tailor-made for the present fiscal profile of new member states – would be to make the application of the medium-term balance threshold contingent upon debt levels, as suggested in the Sapir Report.

Here a note of caution must be entered, however. Evidence on output gaps and budget sensitivities are crucial. If relaxed too far, such reform would create the risk of a country's deficit exceeding 3.0 per cent under adverse cyclical conditions. As implied by the analysis further below, a permitted medium-term margin of 1 per cent or less (in absolute terms) seems nonetheless reasonably safe. Whatever risk might arise of a breach in the deficit limit could, if followed by quick action by the Member State concerned, be justified by allowing for temporary factors.[12]

Putting the First Three Parameters Together; an Illustration

Below is illustrated diagrammatically how the suggested reforms of the first and third parameters interact with one another, contingent upon the second parameter of debt thresholds.

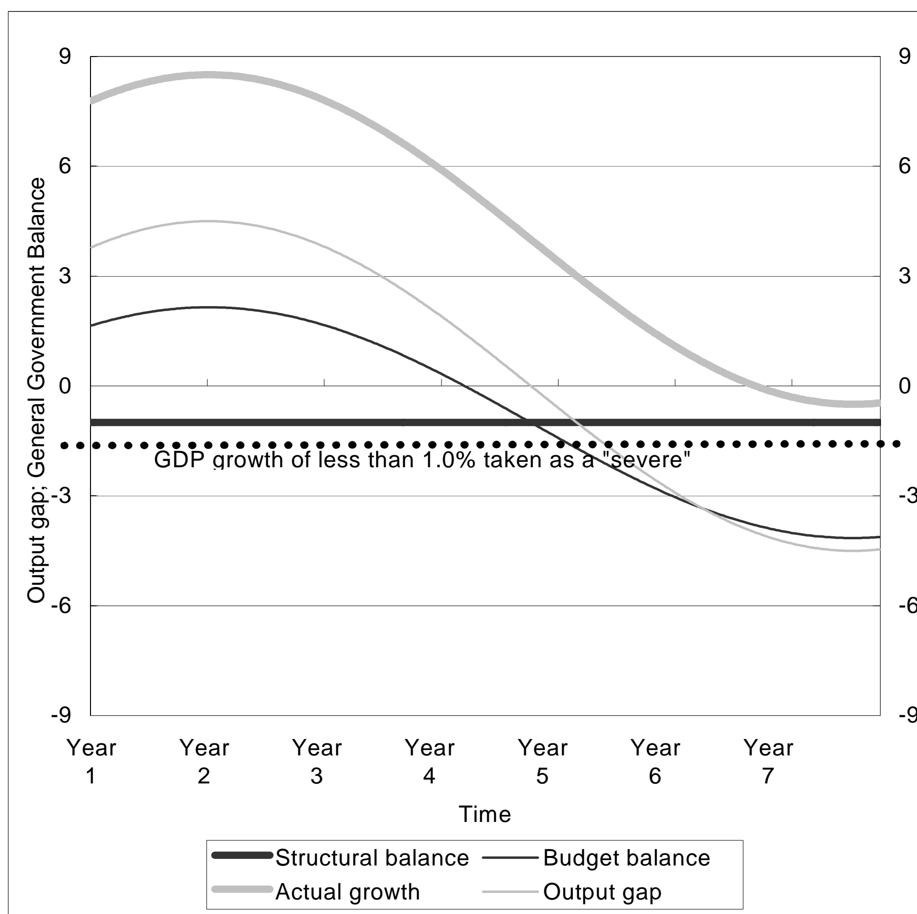
Taking an arbitrary debt/GDP falls below 40 per cent (according to Spring 2004 Commission data, this would include Ireland, Luxembourg, Estonia, Latvia, Lithuania and Slovenia), full exemption from both the medium-term balance and the deficit criteria might be permitted. For ratios of between 40 per cent and 50 per cent a more modest deviation from close to balance or in surplus could be tolerated, perhaps of up to 1 percentage point. This would capture Spain, Finland, the Czech Republic, Denmark, Poland, Slovakia and the UK.

To return to the sustainability diagram presented earlier, the next figure is adjusted to allow the structural balance to be a deficit of 1.5 percentage points. Trend growth is assumed to be 4 per cent per annum (it is assumed that by the time new member states have joined EMU, their trend growth will have settled down) and we assume that "exceptional circumstances" are defined as GDP growth is less than 1 per cent or negative. The same budgetary elasticity and simple sine function as before apply. It is assumed that the country concerned has a debt ratio below an identified tolerance threshold for the medium term "close to balance or in surplus" criteria.

The logic of the figure is simplistic, although not necessary less than the Pact itself. The result is nonetheless reassuring in terms of both redefining exceptional circumstances as constituting a growth rate of zero per cent and of permitting structural deficits of up to 1.0 percentage points for low debt countries. The actual budgetary balance does not fall below 3 per cent until just after actual growth has turned slightly negative.

[12] Note that the language of the Pact in relation to excusing temporary factors should not be confused with the language relating to special circumstances that were used in November 2003: they are different concepts. It should also be borne in mind that the fiscal situations in France and Germany were not temporary but expected to persist for another two years.

Figure 5: The Operation of the Stability and Growth Pact: The Case of a New Member State with Medium Term Structural Surplus



Parameter 4: Sound Institutional Workings

The power of the Council in ultimately applying the Pact has been repeatedly noted as a key weakness. Some added powers are proposed to be given to the Commission under the draft EU constitution in relation to implementing the Excessive Deficit Procedure. Ultimately, however, authority will rest with the Council if the legal provisions of the Treaty governing the EU is to be observed.

The length and complexity of the excessive deficit monitoring procedures are features which could, however, have been addressed to reduce both the long lag between the incidence of a breach of the Pact and its punishment, as well as the opportunity for member states to lobby for support in order to escape sanctions.

5. Conclusion

The latest reform of the Pact has increased, rather than decreased, the scope for the Council to exercise expedient judgement, without creating any offsetting disciplines. It has done this by lengthening of the monitoring and disciplinary timetable in the Excessive Deficit

Procedure and by greatly increasing the scope for country specific considerations to be validly assessed in implementation. Institutionally speaking, the Pact has turned from being a set of fiscal traffic lights to being a set of speed bumps; slowing rather than halting the pace of fiscal decline.

Some of the Pact's substantive provisions have been improved; there is more flexibility for low debt countries in relation to the medium-term fiscal balance and the criterion for a "severe downturn" has been rationalised. These changes would be welcome were it not for the erosion in the credibility of the Pact arising from the decision to increase the Council's facility to exempt high deficits from punishment with reference to country specific circumstances and other vaguely defined criteria. It is hard to see how the Pact can have a simple and transparent application across the European Union when decisions taken under the Excessive Deficit Procedure can be subject to the influence of the fiscal idiosyncrasies of twenty-five member states.

A better approach to reform was possible. The events of November 2003 presented not only a challenge to the Pact, but also in the context of enlargement and population ageing a unique opportunity to reform it. Had that opportunity been grasped we might now have a strong, simplified and credible Pact with which to safeguard fiscal stability and promote fiscal sustainability in Europe. As it is, the opposite appears to be happening. The divergence between the EU's present fiscal position on the one hand, and the fiscal targets for stability and sustainability contained in the Pact on the other is growing. Capital markets and, possibly, the monetary policy strategy of the European Central Bank remain the last effective lines of defence against the fiscal pressures of an ageing Europe.

ANNEX I: KEY DECISIONS RELEVANT TO THE IMPLEMENTATION OF THE PACT

January 2002	Commission	Recommends that early warning be send to Portugal for having missed its budget target for 2001 by wide margin; projected deficit for 2001 was 2.2 per cent, indicating a deteriorating fiscal situation.
January 2002	Commission	Recommendation that early warning be send to Germany as projected deficit for 2001 was 2.6 per cent, indicating a deteriorating fiscal situation.
February 2002	ECOFIN	Council decided not to endorse the Commission recommendations and to close the early warning procedure.
October 2002	Commission	Recommends that excessive deficit exists in Portugal in 2001 and that in the absence of rectifying measures is in prospect for 2002.
November2002	ECOFIN	Council agrees that Portugal has excessive deficit.
November 2002	Commission	Recommends giving early warning to France in relation to a foreseen risk of excessive deficit in 2003.
January 2003	Commission	Recommends that excessive deficit exists in Germany.
January 2003	ECOFIN	Council agrees that an excessive deficit exists in Germany in 2002.
January 2003	ECOFIN	Council agrees and gives early warning to France.
May 2003	Commission	Commission recommends that excessive deficit exists in France and calls for corrective action to be implemented by October in order to prevent an excessive deficit beyond 2004. A similar decision is taken with respect to Germany.
June 2003	ECOFIN	Council agrees and decides that excessive deficit exists in France and calls for France to implement corrective action.
November	French government	French Finance Minister announces intention not to take corrective action in respect of the planned budgetary plans which are forecast by the Commission to result in excessive deficits in 2004 and 2005.
November 2003	Commission	Recommends that “notice be served” on both France and Germany for failing to take the corrective budgetary action in respect of the Commission recommendations of May 2003 as endorsed by the Council.
November 2003	ECOFIN	Council rejects recommendation of Commission to serve notice on France and Germany and effectively puts the Excessive Deficit Procedure in abeyance. In justifying its decision, ECOFIN referred to “special economic circumstances” affecting the budgetary positions in France and Germany.
January 2004	Commission	Commissioner Solbes announces a decision to request clarification from the European Court of Justice in respect of the legality of the ECOFIN decision of November 2003.
May 2004	Commission	Commission initiates the Excessive Deficit Procedure against the Netherlands and adopts a report on the existence of an excessive deficit in Greece.
June 2004	Commission	New Monetary Affairs Commissioner Almunia calls for a loosening of the Pact, by giving more weight to a country’s debt position and to “special economic circumstances” in assessing the acceptability of its deficit.
July 2004	ECJ	The European Court of Justice deems that ECOFIN’s decision to put the Excessive Deficit Procedure in abeyance was invalid, but does so in a manner that does not restore the threat of sanctions against France and Germany.
March 2005	ECOFIN	Recommends reforms of the Stability Pact.
March 2005	European Council	European Council endorses the ECOFIN recommendations for reform and calls upon the Commission to draw up proposals for their implementation.

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