CENTRO STUDI SUL FEDERALISMO

October/2005

THE STABILITY AND GROWTH PACT

Tommaso Rossini

CSF PAPERS

Index

Introduction 7

1 The Stability and Growth Pact: origins and structure 9

1.1 Introducing the Maastricht Treaty ________ 9

1.2 From the Disorder to the Rules ________ 10

1.3 Anatomy of the Rules ________ 12

1.4 The Rationale for Maastricht Rules ________ 14

1.5 Towards the SGP: a Long Term Commitment ________ 16

1.6 The SGP, what is it? ________ 18

1.6.1 The First Regulation 19

1.6.2 The Second Regulation 20

1.7 Conclusions ________ 24

2 The breaching of the Pact 25

2.1 Introduction ________ 25

2.2 Towards an institutional collapse ________ 25

2.3 The breaching of the Pact ________ 27

2.4 An interpretation: the dynamics of European Public Finances and Economy _29

2.4.1 Years 1998-2001 30

2.4.2 Years 2001-2003 33

2.5 Conclusive issues ________ 36

3 Testing the SGP 37

3.1 Introduction ________ 37

3.2 The Pact and some Ideal Sets of Fiscal Rules ________ 37

3.3 Critical Issues concerning the SGP ________ 43

3.3.1 Budgetary Flexibility and Functional Symmetry 44

3.3.2 Disincentives towards Public Investments 49

3.3.3 'Short-Terminism' and the 'Quality' of Public Accounts 53

3.3.4 The European Aggregate Fiscal Stance and the Enlargement Process 56

3.4 A primary opinion on the Pact's Problems ________ 58

4 Reforming the SGP: Literature suggestions 61
4.1 Introduction 61
4.2 The "Golden Rule" of Public Finance 62
4.2.1 Different forms of "Golden Rules" 63
4.2.2 Results and Criticisms 68
4.3 Institutional Reforms 72
4.3.1 Wyplosz's Proposal 73
4.3.2 Other Forms of Authorities 76
4.3.3 Critical issues 78
4.4 "A Permanent Balance Rule" versus "Tradable Deficit Permits" 81
4.4.1 The "Permanent Balance Rule" 82
4.4.2 Problems of the Rule 85
4.4.3 The 'Tradable Deficit Permits' 86
4.4.4 Problems of the Mechanism 89
4.4.5 A Joint Conclusion 90
4.5 Focus on Debt Sustainability 91
4.5.1 The "Debt Sustainability Pact" 92
4.5.2 Calmfors and Corsetti's Way 94
4.5.3 Do We Really Have to Focus on Debt Sustainability? 97
4.6 A "Good Quality Finance Rule" 99
4.6.1 Criticisms on the rule 101
4.7 Conclusions 102

5 The way ahead to the reform of the Pact 105
5.1 Introduction 105
5.2 The European Court of Justice ruling 105
5.3 The debate on the reform moves forward 107
5.4 The Commission's Proposal 108
5.4.1 More focus on Long-term sustainability 109
5.4.2 More country-specific circumstances for the *close-to-balance* clause 109
5.4.3 More consideration of economic circumstances for the EDP 110
5.4.4 Earlier actions to correct inadequate budgetary developments 111
5.5 Assessing the Commission's approach 111
5.6 The reactions by the EU politicians: a new agenda 113
5.7 Germany attacks, France and Italy follow, Juncker enters the debate 114
5.8 The new Stability and Growth Pact 117
5.8.1 Backbone of the proposal 117
5.8.2 The amendments 118

5.9 Conclusions: a new phase into the EU rules ____ 123

5.9.1 Benchmarking with the Commission's Proposal: many discrepancies 124
5.9.2 Economic rationale is weak, if not absent 125
5.9.3 The growth concern is *per se* correct, but in fact misleading 126
5.9.4 Politics, and not Economics, play the key role 127

References 132

List of Tables, Boxes and Charts 141

Introduction

After the decision by European Council on November 25th 2003 to suspend the sanctioning mechanism of the Stability and Growth Pact (SGP), which should have punished France and Germany for carrying excessive deficits in 2004 for the third consequent year, the Pact itself has been declared "defunct"[1] or "refrigerated"[2], but also, quite unexpectedly, "respected in its logic"[3] or "died in its strictest version"[4].
Therefore, as one could easily argue, the already lively debate on the merits and demerits of the SGP suddenly turned into a heated dispute on whether the Pact would have to be reformed, amended or simply scratched. As a matter of fact, in the following months, academics and *think-tanks* have either reproposed their reform plans or elaborated new ones, in a *crescendo* of opinions among the most radical interventionists and the supporters of the incumbent framework. Eventually, at the European Council on 22nd of March, 2005 and after almost one year and a half of debates and political contrasts, the SGP eventually gained a new shape.

With such scenario as a background, this work is aimed at finding out some sort of reasoned opinion on the very essence of the SGP as well as on its renewed structure. Moreover, the ultimate objective of the analysis is to find out whether the new Stability and Growth Pact can be considered better than the old one as well as a sound agreement on fiscal sustainability *per se*.

Moving to the more factual aspects of the work, its outline is as follows. Chapter one is dedicated to a brief history of the SGP and to the presentation of its structure and operational working. Chapter two, instead, deals with the Pact's breaching in autumn 2003, together with an insight into the causes that eventually led to that outcome. In

1 From "The Economist", *"Unstable and Incredible"*, November 27th 2003.
2 From "The Financial Times", *"Ministers conduct late-night burial for EU fiscal framework"*, November 26th 2003.
3 French Finance Minister Francis Mer to "Il Sole – 24 Ore", *"No Sanctions, Brussels defeated",* November 26th 2003.
4 From "The Financial Times", *"EU may yet pay the price of not playing by the rules"*, November 26th 2003.

chapter three a testing of the SGP against some ideal sets of Fiscal Rules is provided, to see how it performs, at least theoretically, against those benchmarks. In chapter four some of the most relevant reform proposals are examined, with the aim of emphasising their merits and demerits and finding whether a *pareto-improving* solution could be found. Chapter five eventually examines the reform process that led to the new Stability Pact and provides a critical assessment of the new document.

Moreover, before starting our analysis, a sort *ex ante* comment would perhaps set the case for continuing the reading. As a matter of fact, whatever the opinions on the topic, the theoretical interests or political beliefs, it seems that an analysis on the issue could be justified for at least a paradoxical consideration: that it is perhaps the first great communitarian achievement which has been defined both as "one of the most remarkable pieces of policy coordination in world history[5]" and, more simply, as "stupid[6]". If it is true that the amplitude of visions makes a topic more interesting, this work would perhaps appear less monotonous than expected.

5 Michael J. Artis, "The Stability and Growth Pact: Fiscal Policy in the EMU", in F. Breuss, G. and S. Griller (eds.), *Institutional, Legal and Economic Aspects of the EMU*, Springer, Wien-New York, 2002.

6 Romano Prodi, President of the European Commission, during a memorable interview in Autumn 2003.

1 The Stability and Growth Pact: origins and structure

1.1 Introducing the Maastricht Treaty

"With or without the Maastricht Treaty, the political and economic climate in Europe in the middle of the nineties has made highly unlikely that the Single Currency will be born in this century". That was what Paul Krugman and Maurice Obstfeldt wrote in the third edition (1994) of their famous "International Economics", a masterpiece for students in Economics. Therefore, even after the Treaty had been underwritten by each member of the future European Monetary Union (EMU), during the years 1992 and 1993, the destiny, or at least the time evolution, of the EMU itself and of its major consequence – the introduction of the Single Currency – was everything but certain.

As a matter of fact, the Maastricht Treaty, which is nowadays seen as the very beginning of a virtuous political and economic decade and the first step towards a long term commitment of monetary stability and fiscal discipline, was signed in the highly unstable framework of the early nineties, and was put under high pressure even during its ratification process, with the risk of a complete collapse of the EMU.

Events such as the rejection of the Treaty in Denmark, during June 1992, the severe currency crises of the following autumn, with the strong devaluations of Great Britain's Sterling against the ECU and then UK and Italy exiting the European Monetary System, some days later, witness very clearly how fragile were the political and economic *equilibria* during those years.

Even the political effort to build consistence and international prestige to the Treaty was highly tormented and, to some extent, unsuccessful: the case of France, searching for a wide approval of the Treaty, in a strenuous referendum campaign emblematically ended with a mere 51.05% of voters in favour of its adoption (Nugent, 2001), may be considered itself as the symbol of the difficulties of the process leading to the EMU.

However, in an *ex-post* perspective, the efforts and attempts of that complicated phase were of crucial importance towards the creation of suitable conditions for the introduction of the Single Currency, and the underwriting of the Maastricht Treaty, even in such difficult years, definitely played the most significant role, together with being the very first step of a long process.

1.2 From the Disorder to the Rules

The Treaty's roots[7] belong to the entire history of the European Community, showing that the birth of the EMU in 1992 may be considered either as the *turning* point of a long process dating back to the Treaty of Rome, or as, of course, its *starting* point.

As a matter of fact, the exigency of an alignment, regarding Monetary and Economic policies, within the European Community members had already been recognised and included in the Treaty of Rome, even if only formally. Of course transferring powers to European Boards would have been impossible at those times, as it would have meant losing sovereignty in too strategic and, at the same time, delicate issues; therefore that objective remained only a fascinating declaration of intent.

However, the favourable climate of the sixties, both from an economic and political-military point of view, progressively contributed to change that theoretical exigency into projects and plans: the European summit at The Hague, in 1969, decided to put under study a project of an economic and monetary union. Two years later, the Werner report was issued, proposing a progressive ten years' plan towards a monetary union, which had been rapidly and favourably welcomed by the member states. Their commitment was soon translated into the creation, in 1972, of the European Monetary Snake, a system allowing exchange rate fluctuations within a fixed spread (+2.25% / -2.25%), that, nevertheless, was soon put under pressure and then abandoned by some currencies during the 1973-75 worldwide stagflation following the oil crises. These events *de facto* caused the Werner Plan to be abandoned and the disorder to undermine the efficiency of the

[7] For an historical overview of the process leading to the Treaty see for example Zanghi' (2000), Apel (2000) and Nugent (2001). A useful institutional and legal point of view has been found in Tesauro (2003).

monetary system, with national currencies exiting or entering it, following interests of pure national policy.
Moreover, after having turned out from the most critical point in the crisis, the idea of the monetary union was relaunched and, in December 1978, the European Monetary System (SME) was instituted and finally implemented in March of the following year, together with the introduction of ECU (European Currency Unit), a "virtual" currency – as well as the father of Euro – formed by a basket composed by those of all member states. This system was intended as a sort of restyling of the older "Snake", reintroducing a fluctuation spread but abandoning the *one-size-fits-all* feature, allowing for either wider spreads for certain weak currencies (such as the Italian Lira and the Greek Drachma) or periodical realignments of the parities, with the consensus of Communitarian Authorities.
Indeed such system did not transfer any significant power in Economic or in Monetary issues to European, supra-national Boards, which kept their advisory and counselling role, rather than acquiring powers, and neither the European Single Act of 1985 was able to significantly change such framework.
The turning point of the process is widely and traditionally identified in a 1989 proposal from the European Commission, chaired by Jacques Delors, of a three-stage convergence plan to gradually introduce a fixed exchange rate mechanism among the twelve Member States, together with a binding discipline on public finances and, finally, a Single Currency. This ambitious plan was to be implemented by the creation of two Intergovernmental Conferences, one centred on the Economic and Monetary Union and the other on the Political Union, both aimed at putting the basis towards the building up of a Treaty of the Union.
Regarding Economic and Monetary issues, the plan identified three main steps: the First Stage, basically, was aimed at introducing the European Monetary System throughout all the Member States and at arranging for a closer coordination of economic and monetary policy within the *existing* institutional framework. The Second one was instead intended as a gradual transition phase – following the idea of a "learning process" (Stark, 2001) – to progressively limit exchange rate fluctuations among the different currencies and to start centralising some policy decisions and functions at the European level. Finally, the

Third one conducted towards the creation of the Single Currency and of the European Central Bank.
The Treaty, which was signed by the European Finance and Foreign Ministers Council in the city of Maastricht, on 7th February 1992, set the beginning of Stage Two on 1st January 1994 and that of the Third one no later than 1st January 1999.

1.3 Anatomy of the Rules

The Treaty itself was centred on a strict stability orientation, aimed at ensuring an effective discipline among the European States and at guaranteeing a complete convergence towards the Stage Three of EMU, together with playing a deep role in building political and economic credibility with regards to the entire process.
More specifically[8], the Title Seven of the Treaty (Articles 98 – 124; once articles 102A – 109M) is centred on "economic and monetary policy" issues, organically presenting some guidelines in policy-making matters (Articles from 98 to 102), together with some Public Finance and Fiscal prescriptions (Articles 103 and 104), Monetary Policy issues (105 to 112) and, finally, Institutional and Transitional Provisions (112 to 124).
Focusing on Articles 103 and 104 – the bulk of the Treaty's prescriptions on Public Finance issues –, it is possible to identify the first one with the well-known *No Bail-Out Rule* and the second one with the Excessive Public Deficit and Debts rules.
Article 103 firmly states that *"The Community does not respond of and is not responsible for the commitments of National Administrations, Regional or Local Boards or other Public Boards, other Public Law Organisms or Public Firms of whatever Member State"*, therefore declaring impossible for the Community (the ECB, substantially) to bail-out a State in financial crisis. This rule has to be considered in connection with Article 105, stating that the main goal of the European System of Central Banks (SEBC) is "to keep price stability" and with Article 21 of SEBC Protocol, declaring impossible for the European Central Bank to buy national or local bonds of European States. Therefore the idea is that, emphasising the impossibility of financial rescue of any State or Public Board – either directly engaging in open-market operations or acting as the

[8] All the sentences of this paragraph in *inverted commas* come from the European Codex of Nascimbene (2003).

lender of last resort in a bail-out *scenario* –, this group of prescriptions should ensure discipline by a sort of *ex-ante,* multi-edged menace.

Moreover, the Treaty includes a procedure against the creation of excessive deficits, explained in Article 104 and – regarding specific parameters – in the attached Excessive Deficit Procedure Protocol, to strengthen such menace. The core elements are two strict limits on Deficit and Debt values – respectively, 3% and 60% of GDP – which are intended to ensure debt sustainability (and therefore overall national financial sustainability) and to prevent unvirtuous behaviours, both from a political and an economic-financial perspective, from damaging public finances, as it had been doing during the eighties.

However, a figure above these parameters does not automatically imply the presence of an "excessive deficit": this must be decided by a corresponding Council Resolution, preceded, in turn, by an assessment and recommendation of the Commission. But the Commission and the Council – and this is the critical element – are not *obliged* to submit either an assessment or recommendation, therefore making difficult to objectively determine the presence of an excessive deficit (Stark, 2001).

The difficulty of such Procedure is actually linked to the fact that it allows for certain exceptions. First of all, a deficit is not considered excessive if either the ratio has "declined substantially and continuously" and reached a level approaching reference value or, alternatively, if the excess over the reference value is only "exceptional and temporary" – i.e. a downturn in the economic cycle – and the ratio remains close to that value. In addition, the ceiling on public debt at 60% of GDP may be violated if the ratio is "sufficiently" diminishing and reaching the reference value at a satisfactory pace. Thus, only if the Commission realises that the member state fails to fulfil at least one of these two *criteria,* the Procedure may start its way towards the Council's assessment and decision, which does not automatically have to be in accordance to the Commission's recommendation. And, finally, even if the Council states that the excessive deficit exist, its Recommendation would be centred on "bringing the situation to an end within a given period of time", with the strongest sanction for no compliance consisting in "making its Recommendation public".

At this stage of the EMU, no other sanctioning powers were disposable.

1.4 The Rationale for Maastricht Rules

"By definition, the source of an excessive deficit must be some type of distortion"
Roel Beetsma

Focusing on a theoretical background, and considering that literature is very wide regarding this issue, it is possible to organically classify in some major points the core reasons justifying the presence of fiscal rules within a Monetary Union.

a. First of all, following among others Kenen (1969) and De Grauwe (2000), if in the context of a Monetary Union it would be desirable to concentrate a significant part of the national budgets at a *central* level – in order to insure countries enjoy automatic transfers, if hit by asymmetric shocks – it is also clear that such centralisation could not always be implementable, as the EU experience may suggest[9]. Therefore, in this case, if the national fiscal policies have to be used in a *flexible* way, to tackle country-specific shocks, some kind of rule preventing countries from undertaking unvirtuous fiscal behaviours leading towards debt unsustainability may be desirable. More specifically, the key reasons for linking the *carrot* of international monetary stability to the *stick* of national fiscal discipline follow below from points *b* to *f*.

b. The core element, as well as justification, of the presence of fiscal rules is that if a country moves towards debt unsustainability, it will generate negative externalities towards the other partners of the Monetary Union, by pushing up interest rates. This is a traditional, well-consolidated opinion, shared both by the European Commission and some major authors (Bovenberg, Kremers, Masson, 1991; Giovannini, Spaventa, 1991).
This surge in interest rates has, in turn, several negative implications: (i) it makes the service of debt more expensive, shifting public resources to a low productive category of expense, (ii) it has negative effects for private investments and resource allocation and

[9] Of course a stronger European Political Union or Federation could make such policy prescriptions both concrete and applicable.

(iii) it has an adverse effect towards the ECU, whose exchange rate would be raised, eroding exports competitiveness and, consequently, damaging the economy (Buiter, Kletzer, 1991; Buiter, Corsetti and Roubini, 1993).
In addition, the common counter-opinion against this issue – the ability and effectiveness of capital markets in disciplining profligate governments – has been demonstrated ambiguous (Restoy, 1996) and, on a more empirical basis, it has been shown that higher interest rates during the 1980s did not prevent European countries from pursuing unsustainable fiscal policies (Corsetti and Roubini, 1993).

c. There is a theory, called *The Fiscal Theory of the Price Level,* which says that in the mid-run, fiscal discipline allows to contribute keeping price stability and low and stable inflationary expectations. Indeed, if the fiscal policy does not assure public sector solvency for *every* price level, the monetary policy will tend to lose control over the price level itself. As a matter of fact, public balances out of control would create perverse incentives that would induce the Central Bank to abandon its orthodox approach in monetary issues, moving towards expansive policies to avoid financial crises. In conclusion, fiscal policy must keep under control deficits and debts in such a measure to guarantee the solvency constraint for whatever level of interest rates and prices (Giudice, Montanino, 2003; Buiter, 1999).

d. Indeed, large deficits and big debts place constraints on a country's ability to act effectively in the different stages of the business cycle, to stabilise it; as a matter of fact, chronically having high structural deficits implies a loss in the degree of automatic stabilisation. This issue of course calls for fiscal discipline that creates good balance positions in the mid run, allowing for short-term manoeuvring. (Stark, 2001).

e. In addition, another important reason seems to indirectly justify the Maastricht constraints on a different basis: the *Golden Rule* of Public Finance, stating that the investments may be financed with debt emission – in contrast with current expenses, to be financed with current revenues (European Commission, 1990). Since empirical analysis over the period 1974-1991 have underlined that public investments in Europe have been close to the 3% of GDP, and considering a nominal growth rate of 5%, together with the equilibrium condition $d = x \cdot b$ (where d is the *Deficit / GDP* rate, x is the nominal growth rate and b is *Debt / GDP* one), a pure algebraic consideration automatically implies a value for b: 60%. Therefore, Maastricht Parameters are consistent with that Rule, and – not surprisingly – follow very strictly the German's Public Finance values of late eighties, showing that the most "disciplined" country wanted to be guaranteed from misbehaviours that could undermine stability of the System as a whole (Majocchi, 1998).

f. Finally, even if not theoretically and scientifically rigorous, an historical as well as political issue gives a fascinating rationale for implementing the rules: according to Buchanan (1997), actually, fiscal rules were generally not written into constitutions and laws for a long time, as they were rather part of an accepted set of attitudes about how a Government should carry on its fiscal affairs. In recent decades, instead, under the influence of the sustained, high deficits of the seventies and eighties, the debate has gradually focused on the introduction of explicit rules in legislation.

Now that some reasons *pro* setting parameters have been presented, it is mandatory to say that there are of course some *contra*, varying in a full spectrum from some direct, technical aspects to wider considerations, affecting long-run implementation problems (such as, basically, the impact on national counter-cyclical action and the perverse effects towards investment financing). However, these problems and criticisms will be examined in Chapter 2, centred on the SGP and its implications: the idea is that most of SGP problems have their origin in the Maastricht Parameters and, therefore, it seems more logical to analyse these *twins* issues together.

1.5 Towards the SGP: a Long Term Commitment

Some proposals about how to supplement and enforce the Maastricht's rules started to appear already at the beginning of stage two of EMU, started in January 1994.

The German Ministry of Finance, Theo Weigel, expressed its interest in additional budget provisions for states entering into Stage Three of EMU for the first time in London, at a conference held by Goldman Sachs in May 1995.
That position had, basically, the aim of persuading the German public opinion that abandoning the German Mark would not have implied new risks for price stability. As a matter of fact, the Germans had faced two hyperinflations in one century and therefore it could not have impressed a certain widespread scepticism linked to the imminent exchange of their currency – the symbol itself of economic recovery after the war – in favour of one whose stability, either internal or external, could not have been foreseen with certainty (Stark, 2001; Crowley, 2003). In addition, there was also the eagerness of sending another strong, positive signal to the markets, which would have contributed to create greater soundness and credibility for the whole EMU.
Indeed, such a position has been proved, in an *ex-post* perspective, to have been crucial for the development of EMU: Costello (2001) arrives at saying that, in late 1995, the future of the EMU project depended on the German Government being able to convince the sceptical *German* public that the Euro would have been as stable as the D-Mark.
The German point of view was soon translated into a proposal presented by speech of the Ministry himself on November 7, 1995 at the *Bundestag* calling for a "Stability Pact for Europe" (*Stabilitätspakt für Europa),* which would have ensured additional commitment by member states to adopt sound fiscal policies practices in stage three of EMU as well. The main concern was that countries, after having entered the third stage, might have fallen back to their old fiscal *routines,* if no budget rule would have bound their behaviours. Therefore, in a letter dated 10 November to fellow EcoFin Ministers, Mr. Weigel made a proposal centred, basically, on three issues: (i) converting the 3% GDP reference value from its perceived status a "target" to an "upper ceiling" which could only be breached in extreme exceptional cases; (ii) introducing automatic decision-making by leaving no scope for discretionary judgment by either the Commission or the Council; (iii) calling for a new Stability Council comprising only member states participating in the Euro area, meeting twice a year to review and implement the Pact.
Such a kind of "all sticks and no carrots" proposal (Costello, 2001) opened the way to an intensive eleven months period of talks and debates among the European Partners and

Institutions, with the French finance Minister, Mr. Arthuis, speaking first shortly afterwards and expressing strong accordance to Mr. Weigel's proposal as well as stressing the importance of the beginning of negotiations on this issue.

The Commission[10] expressed a first evaluation of the proposal on 10 January 1996 in a document called *Towards a Stability Pact*, whereas a more profound analysis of the issue was dealt with in *A Stability Pact to ensure budgetary discipline in EMU* of 18 March, but a change – a stiffness, indeed, of its position – turned up into a note of 19 July, under the name of *Ensuring budgetary discipline in stage three of EMU.* Here the Commission firmly declares: "Keeping budgetary discipline in stage three of EMU represents an essential condition to exploit all benefits from the single currency. The reference value of 3% of GDP for deficit must be considered an upper limit in normal circumstances. The strategy has to be founded on (...) mid-run balance objectives *close to balance or in surplus*, which allows staying under the 3% ceiling in normal conditions and a certain differentiation among the member states".

On the other hand, at the informal EcoFin council in Verona (April 1996) and at the formal one in Florence (June), Finance Ministers debated and developed Mr.Weigel's proposal, taking account of the Commission's position and of the political need of not introducing further strict criteria to enter the EMU (Giudice and Montanino, 2003). Finally, a sort of conclusion – even if not the ultimate one – had been reached at the European Council in Dublin (12-13 December), in a strenuous summit that has been remembered in the history of council meetings as the "Dublin Marathon" for the 24 hour lasting meeting, where some kind of compromise over the SGP had been reached. Basically, the Council enjoined the ECOFIN to subject the Commission's Proposals for the two Regulations to careful scrutiny and to work out a draft Resolution for the SGP, which the European Council was to accept in June 1997, transforming the proposals into real, binding rules.

1.6 The SGP, what is it?

According to Michael J. Artis (2002), the answer – indeed quite emphatic – should be that the Pact is "one of the most remarkable pieces of policy coordination in world

history" and that "its construction makes it in some respects comparable to the founding of the Bretton Woods system".
Moreover, adopting a more concrete approach and referring back to the next chapter for an analysis of the *grandeur* of the SGP, it is possible to say that it consists of three distinctive components[11]:

(i) Two European Council Regulations (1466 and 1467/97);
(ii) A Resolution/Directive (17/6/97, #26);
(iii) An Opinion of the Monetary Committee ("Opinion on the Content and Format of Stability and Convergence Programmes", of the 12 October 1998).

The Pact, however, is essentially constituted by the two Council Regulations, with the Resolution as a political guidance and the Opinion as a clarification for implementation purposes.

1.6.1 The First Regulation

The First Regulation *("On the Strengthening of Surveillance of Budgetary Positions and the Surveillance and Coordination of Economic Policies")* deals with the preventive dimension of the Pact, and, basically, it lays down an "early-warning" system in order to prevent a Government deficit from becoming excessive, having Article 99 (ex 103) of the Maastricht Treaty as its legal base.
The rule disposes that Member States have to submit Stability Programmes[12] each year, before 1st March, to the European Commission, who, after an examination, in turn send them to the Council. The Programmes have to be based on a 4 years' time horizon (including the one in which they are presented), and have to include the following elements:

[10] A detailed framework of the Commission's position has been found into Majocchi, (1998).
[11] An exhaustive analysis of the rules has been found in Cabral (2001) and Crowley (2003).
[12] For States not having adopted the Euro yet, they are called "Convergence Programmes".

- An objective of "a medium term budgetary position *close to balance or in surplus* and the adjustment path towards this objective";
- Forecasts regarding major relevant economic variables, such as real growth rate, inflation and employment rates;
- A description of the measures which have to be undertaken to hit the targets and an evaluation of the impact of such measures on the Public Balance;
- An assessment of the likely impact on Deficit (*"d"*) and on Debt Stock ("*b")* of variations from the forecasts of the main economic variables.

The Council, following a recommendation from the Commission, within at most two months of the submission of the Programme expresses a *Council Opinion* assessing "whether the medium-term budget objective in the Stability Programmes provides for a safety margin to ensure the avoidance of an excessive deficit" and, if unsatisfactory, requiring to adjust the Programme.
The implementation of the Programmes will then be monitored by the Council, who has the power to send recommendations (the so-called *early warnings)* – first on a private and then on a public basis – if "a significant divergence of the budgetary position from the objective" is identified[13].

1.6.2 The Second Regulation

The Second Regulation (*"On speeding up and clarifying the implementation of the excessive deficit procedure"*) deals instead with the dissuasive – as a complement to the first, preventive one – part of the Pact, and puts its basis on Article 104 (ex 104c) of the Maastrich Treaty.
The Regulation provides a clarification on how to *implement* Article 104, establishing a complete – even if not completely exhaustive – framework of the several steps which

[13] The conditions for activating this warning mechanism are not identified by the Pact, and, in particular, it is not specified in a clear way what is to be intended with "significant divergence". Following the main interpretation, three factors have to be considered: (i) the *dimension* of the divergence – that is the quantitative impact on the Public Balance, (ii) the *reason of the divergence*, that may be explained with either cyclical or discretionary factors and (iii) the *risk* of violating the 3% ceiling (Giudice and Montanino, 2003).

constitute the Excessive Deficit Procedure, from (a) their identification and the definition of the correction path, to (b) the application of sanctions.

(a). The key issue of this part of the Regulation is of course that of explaining how to decide whether and when a deficit above the 3% ceiling has to be considered excessive. As a matter of fact, Article 104 of the Treaty states that *"if the excess over 3% is only exceptional and temporary and the ratio remains close to the reference value",* the deficit is not considered excessive, but, of course, this expression has to be explained in a deeper and more detailed way.
The Regulation indeed considers that the excess over the 3% can be considered exceptional if (i) "it results from an unusual event outside the control of the Member State" (for example, a natural disaster) or (ii) "it results from a severe economic downturn". Such a downturn, sequentially, turns up if "the annual fall of real GDP is at least of the 2%". And here the document further explains:

- If the GDP falls by at least 2%, the excess is exceptional and the Council *does not* decide that there is excessive deficit[14];
- If it is between 0.75% and 2%, the Member State can present to the Council arguments justifying the excess;
- If it is less than 0.75%, the issue of "exceptional" should not be invoked.

So, turning to a more concrete *scenario*, what if a deficit is above the 3% ceiling in year *t*? First of all, data regarding the excessive deficit in year *t* are due to be reported before 1st March of the year $t + 1$, and then by June of year $t + 1$ the Council must have decided *the existence* of an excessive deficit and made a recommendation to the Member State concerned "to bring the situation to an end within a given period" (Article 104(7)).
Such a recommendation gives 4 months to take effective action to correct the deficit; after this period of time, if the Council considers that no effective action has been

[14] However, even in this case, the Commission has to initiate the procedure of issuing the report (under article 104(3)), that is sent to the Economic and Financial Committee (ECF, the once *Monetary Committee* before 1 January 1999), who expresses its opinion and then lets the Commission think whether to send a recommendation – signalling an excessive deficit even in this situation – to the Council or not.

undertaken, a notice under article 104(9) is given to the State within a month. At this point, failing to comply with the notice of the Council would imply being sanctioned within two months.

This means, consequently, that sanctions should be imposed – in a context of a perfect, on time application of the rules – before the end of the year $t + 1$, that is before the end of the year *following* that in which the excessive deficit occurred.

However, there is the possibility of allowing a longer period of time for the correction of the excessive deficit, because the Pact states that the above mentioned rules holds "unless there are special circumstances". This is due to the fact that the Council did not want to be very rigid in this area, allowing a case-by-case analysis of each excessive deficit and the causes behind it (Cabral, 2001).

(b). The sanctioning procedure is the last step of the dissuasive part of the Second Regulation of the SGP and, to a first sight, appears rather tough. However, two issues are to be considered: first of all, if the situation arrives at this stage the member state concerned has already been given enough opportunities to correct the deficit; in addition – and this is the key element – sanctions cannot be imposed automatically, allowing a certain degree of manoeuvring for the Council before such a hard measure is taken.

If the Council decides to impose sanctions, a non-interest-bearing deposit at the ECB will be required from the Member state concerned, following Article 104(11), with, therefore, the pecuniary cost of the deposit being the interest foregone, which is not highly significant[15], and the "reputational" cost being the significant one[16] (Giudice and Montanino, 2003).

The deposit will remain constituted until one of the two following cases occurs: (i) if after two years the excessive deficit has not been corrected, then the deposit is turned into a fine; (ii) if, before the end of the two years, the Council decides that action has been

---

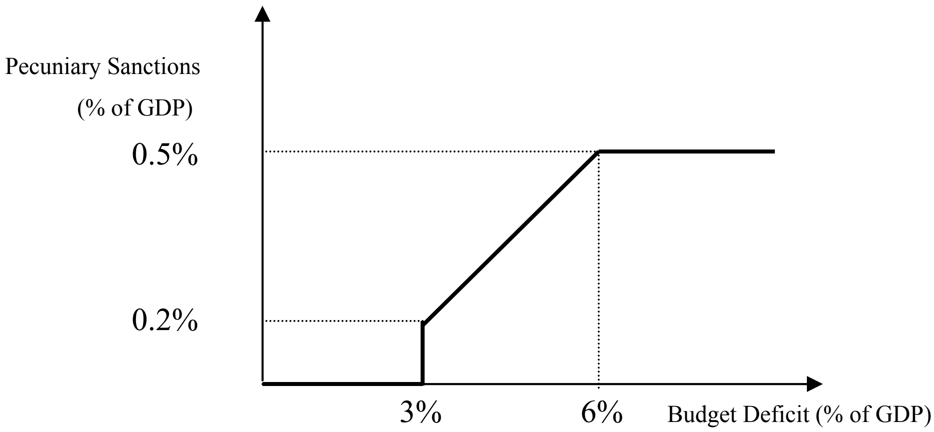
[15] Giudice and Montanino (2003) have estimated that, under the hypotheses of (i) a deficit under the 4% and (ii) an interest rate of 2/2.5% (assuming bonds with short redemption), the total cost would be between 0.004% and 0.0075% of GDP. Even with interest rates at 4%, the total cost in the worst-case scenario (i.e. sanctions of 0.5% GDP), would be 0.02% at maximum.

[16] Bosi (2000) speaks about the issue of reputation going even further: in his opinion, actually, "the moral susasion from the EU Council is definitely of decisive importance" among the different costs of sanctions.

successfully taken, then the deposit can be returned to the Member State, with, formally, the abrogation of its previous decision regarding the presence of the excessive deficit.

Indeed, the scheme of sanctions may be easily understood with the aid of a chart, showing the link between Budget Deficit (% of GDP) and the value of sanctions themselves:

Graph 1. The SGP's sanctioning mechanism



Source: Cabral (2001), in *Brunila et al.* (2001), page 150.

As the chart above suggests, the amount of the deposit is calculated on the basis of the excess over the 3% deficit ceiling and by a linear formulae:

*Deposit = 0.2 + 0.1 * (Deficit as a % of GDP – 3% GDP)*

The idea is, therefore, that after the initial fixed amount of 2% of GDP, a variable part of 0.1% GDP of deposit is required for every 1% GDP above the 3% ceiling; however, the total amount of the deposit cannot exceed the 5% GDP value.

Finally, in the case of deposits turned into fines, the yield of sanctions is distributed among the virtuous Member States, in proportion to each State's share in overall European GDP – instead of flowing into the Communitarian Balance, as it has appeared politically unappropriate to benefit also the States not adopting the Euro, for either political choice or inability to converge (Majocchi, 1998).

1.7 Conclusions

In this first chapter, it has been shown that the current shape of the SGP reveals a high *path dependency,* considering the long convergence process towards the building up of the EMU and the "ups and downs" of the political and economic climate in Europe during those years. Indeed, it has been illustrated that its ultimate justification crucially depends on the leadership role played by Germany, during the eighties and nineties, and on its desire to avoid importing financial instability from the low disciplined countries of Europe, especially the Mediterranean ones.

Therefore, the political dimension of the SGP may plainly appear under its economic and financial veil, confirmed by the analysis of its rules and parameters, the surveillance mechanism and the sanctioning one: the image emerging is that of a huge, complex *insurance measure* against the risk of leaving the certain (the D-Mark) for the uncertain (the Euro). To put it with the razor-sharp words of *The Economist*[17]: "the Pact is a political totem […]. In particular, the Germans, with traditionally the strongest economy and currency in Europe, were loth to sign up to a monetary union with Italy, given its tradition of mountainous debts, a weak currency and high inflation. So, before the great euro wedding, Germany insisted on a pre-nuptial contract written in blood: the Stability and Growth Pact".

However, as it will be shown in great detail in the next chapter, the analysis of the first years of the life of the working of SGP suggest some positive considerations, together with some problematic considerations to be addressed and explored. In addition, complex issues regarding the incentives generated by the Pact, as well as some obscure problems, hidden by years of good economic cycle, have recently turned up and have stimulated a significant debate among economists, politicians and opinion makers. Starting with next chapter, such debate would be carefully addressed, with the aim of finding out a solution – or, at least, an accurate judgement – to the Pact's current *impasse*.

---

[17] From The Economist, *"Reforming the Stability and Growth Pact?"*, October 24th 2002.

2 The breaching of the Pact

2.1 Introduction

This brief chapter is intended to provide a quick recall and analysis of the events that led towards the breaching of the Stability Pact at the EcoFin Council of November 25th, 2004, moving from a chronicle of the facts towards an assessment of the underlying economic and budgetary developments. The idea is to express some judgment on the drivers that were acting beneath those events and to possibly provide some *ex post* conclusions on the facts themselves.

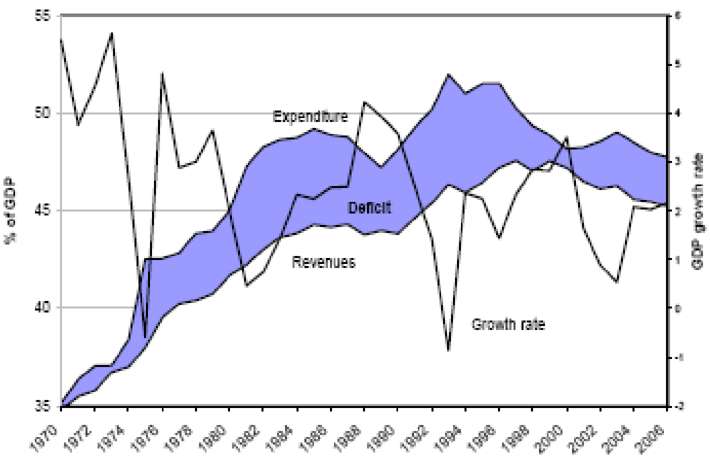
The structure of the chapter is the following: first of all, an insight into the early years of the working of the SGP is provided (paragraph 2); then a description of the breaching of the Pact, together with the political repercussions (paragraph 3); after that, an analysis of Public Finances and Economy in EMU (paragraph 4), to appraise what were the real drivers beneath the breaching of the rules; finally, some conclusive considerations on the topic (paragraph 5).

2.2 Towards an institutional collapse

Following its approval in late 1997, the Pact *de facto* started to work at the end of 1998, with the first submission of the Stability Programmes by the Member States and, indeed, in the years following its introduction, it seemed to work properly. As a matter of fact, the first signs of macroeconomic stability soon started to emerge in the European Economy and Public Finances, still harmed by the monetary and currency tensions of the early nineties. Budgetary discipline and consolidation started to develop, while inflation and interest rates began to converge to levels substantially below those of the beginning of the decade. By the start of EMU in 1999, all of the Euro-area member countries (except Greece) had succeeded in bringing their deficit under the 3% of GDP threshold, an achievement that becomes even more outstanding when comparing the 1992-1998 average EU deficit value, 4.5%, to the 1998-2003 value, 1.5% (IMF, 2005). Overall, a high degree of macroeconomic stability was achieved in the whole European economy, mainly as a result of an impressive budgetary consolidation (Deroose and Langedijk, 2005) amongst most European partners.

Anyway, soon after the start of the monetary union and the launch of the Euro, the consolidation effort began to ease up and budgetary positions started to worsen, coming back closer to the reference thresholds and thus reverting the adjustment path successfully followed so far. As the chart below plainly suggests, while a clear trend of deficit downsizing can be identified in the years 1997-2000, in the following ones the gap between revenues and expenditures started to widen, boosting the deficits all over EU Member States.

Graph n.2 – Main trends in EU aggregate Deficit, Revenues and Expenditures



[1] *Excluding UMTS licence proceeds.*

Source: Commission services.

Source: Deerose and Langedijk (2005).

In January 2002 the relatively calm climate at the EU Institutions level started to deteriorate, following the announcement of a recommendation by the Commission to issue *Early Warnings* to both Germany and Portugal, because of their budgetary situation being worse than expected, with deficits coming dangerously close to the 3% threshold. Despite some debate among EU institutions and Member States over the following months, which actually only shifted the decision forward, in November 2002 the Council declared that Portugal had an excessive deficit and had to correct it. Germany, in the meantime, remained somehow aside, despite having a situation just less worrying than Portugal and still showing tangible signs of deterioration in the budgetary positions, witnessed by the clear breaching of the 3% reference value[18].

Eventually, as the situation kept on worsening and pressures from all sides kept on mounting, in January 2003 Germany and France – which was also following Germany's unpleasant budgetary trend – were judged by the Commission to have run excessive deficits in the year 2002 and were ordered to correct their imbalances by the end of 2004. However, while the end of 2003 was approaching, it began clearer and clearer that neither France nor Germany would have met the correction deadline, moving towards breaching the deficit threshold for the third consequent year. Tensions at the EU level were again shaking the EU boards, since a decision concerning the two biggest economies – as well as founding fathers of the Union – was urgently needed.

2.3 The breaching of the Pact

Not unsurprisingly, the EcoFin Council held in Brussels on November 25th, 2003 agreed to suspend the sanctioning mechanism of the SGP that should have punished France and Germany. The extreme attempt of reconciliation proposed by the Commission, asking for structural deficit[19] cuts of 0.8% in 2004 and 0.5% in 2005 for Germany and of 1% and 0.5%, respectively, for France, allowing one more year – the 2005 – to bring public finances under control and keep free from the danger of sanctions, broke down under the counter-attack of the two states refusing to comply with the recommended cuts. The result was a weaker agreed set of request[20]: Germany was recommended to realize a

---

[18] See next paragraph for a more detailed analysis of the figures.

[19] This means manoeuvring on the CAB (The *Cyclically-Adjusted Balance,* excluding cyclical elements as well as one-off measures) rather than on the nominal deficit value. For a rigorous definition of the concept see for example Fisher and Giudice (2001), in Brunila A. et al., *"The SGP – The architecture of Fiscal Policy in EMU"*, Palgrave, page 163.

[20] Although a radical breach of the Commission's requests had been made by France and Germany and the 12 members of the Euro Group had eventually rejected the recommendations with a 7 to 4 majority (Spain, Holland, Austria and Finland were against; Italy abstained), the meeting formally ended with a resolution, approved at the unanimity, in which the ministers together reaffirmed the "central role of the SGP", the commitment "to apply its rules", paying attention to "the surveillance framework".

0.6% cut in 2004 and 0.5% in 2005, while France faced a 0.8% and 0.5%, respectively, following the values of their *in fieri* Financial Bills for the new year.

France and Germany's refusal to accept the Commission guidelines was confirmed at the European Council on December 12 and 13, 2003, where the political solution not to sanction the two unaligned states was implemented, just some hours before failing to approve the Convention's Draft of the European Constitution.

The highly tormented debate over the SGP and its implementation, therefore, ended, at that stage, in a precarious political climate, with politicians, economists and institutions siding either in favour or against the Council's decision.

Romano Prodi, the European Commission President – as well as the one who defined the Pact "stupid", referring to the perverse incentives it entails – declared himself "deeply regretted"[21] regarding one of the most flagrant breaches of the European rules. He added[22] that "Rules are not to be chosen as meals at the restaurant. (...) It is not possible to use extemporaneous measures to suspend or amend the Pact each time its rules are too strict or inconvenient". On the other hand, Giulio Tremonti, Italy's Finance Minister and chairman of the EcoFin Council, at the end of the meeting declared[23] instead that the day had been "an ordinary as well as intelligent day of management of the Stability Pact"; in the same context, Francis Mer, French Finance Minister, commented his victory against the Commission with a highly political declaration: "Not only the logic of the Pact has been respected, but the aim of economic coordination set by the Pact has been targeted".

The European Central Bank (ECB), conversely, declared it was worried for the "serious dangers"[24] such decision could have implied regarding the surge of interest rates; the private sector, in contrast, did not seem so worried – emblematically, on the day after the EcoFin decision, an investment banker from Goldman Sachs, an American Investment Bank, declared to the Financial Times that the events "were not that a big deal".

Moreover, and finally, it seems interesting to report the German point of view, as it embodies some significant issues, if we adopt an economic perspective, aside from the

---

[21] *The Financial Times*, *"ECB warns as Paris-Berlin deal leaves euro pact in crisis";* November 26, 2003.

[22] *Il Sole – 24 Ore, "Prodi: a strong government for the Economy";* November 27, 2003.

[23] *Il Sole – 24 Ore, "No Sanctions, Brussels defeated";* November 26, 2003.

[24] *The Financial Times, "EU may yet pay the price of not plying by the rules";* November 26, 2003.

political one. The words[25] of Walter Scholër, the Social Democrats budget expert in Parliament, are the following, furious ones: “Mr. Solbes tells us to make structural reforms, which we do. Then he says we should try not to kill growth, so we have tax cuts. Then he comes with an additional €6bn in cuts, just when domestic demand is the weakest in a decade”.

Even at this very early stage of the analysis, therefore, a few key points of the debate on the SGP seem to emerge and provide some guidance on the *pros* and *cons* of its working.
First of all, the political dimension of the subject reaffirms itself deeply, with the European control over national budgets – *national sovereignty,* to a certain extent – being the critical element. Thus, a direct confirmation of last chapter’s main finding – that the SGP was built under strong political pressures and following precise political aims – seems to be plainly confirmed.
In addition, two issues in the declaration by the German Walter Scholër appear important, if not crucial: the failure of National Governments to act anti-cyclically when demand is weak and the Pact places its constraints, and the difficulty (or perhaps unwillingness) to effectively perform structural reforms. It seems therefore clear that these issues should be carefully taken into account when dealing with the Pact’s problems and, possibly, when addressing some reform proposals.

2.4 An interpretation: the dynamics of European Public Finances and Economy

Before moving on towards analyzing what happened after the breaching of the Pact recalled above, an in-depth analysis of the recent data from EU Public Finances seems appropriate, to provide a guidance on understanding *why* the SGP had come so much under fire and *why* it had been eventually violated.
Following both Cabral (2001) and Giudice and Montanino (2003), it seems appropriate to distinguish between two phases in the Pact’s life, prior to its breach: (a) the first one from

1998 to 2001 and (b) the second from 2002 to the end of 2003. Indeed, the first refers to years of good economic cycle and of Public Budgets' recovery, with the Pact not placing significant constraints on Fiscal Policies and allowing considerable room for Governments' manoeuvring, while the second one shows a widespread worsening of the budgetary positions, due to the downturn in the Global Economy as well as the uncompleteness of structural adjustments and the effects of expansive policies of the previous years.

2.4.1 Years 1998-2001

As Table 1 below suggests, the Aggregate Deficit in the EMU quickly passed from -2.3% of GDP in 1998 to a remarkable +0.1% in 2000, while the Debt Stock from 73.7% of GDP to 70.1%, respectively.

Table 1. Growth and Budgetary Positions in EMU (Years 1998 – 2001)

Year	Balance (% of GDP) *Net borrowing* (-) or *Net Lending (+)*	Structural Deficit (CAB)	Debt Stock (% of GDP)	Real GDP Growth Rate
1998	- 2.3	- 2.3	73.7	2.9
1999	- 1.3	- 1.7	72.7	2.8
2000	+ 0.1	- 1.8	70.1	3.5
2001	- 1.6	- 2.1	69.2	1.5

[25] *The Financial Times, "Surprise at Eichel's 'emotional response'";* November 26, 2003.

Source: European Commission, *"Public Finances in EMU – 2003"*.
Data from *Table I.1,* page 5.

This significant overall performance may be explained (Giudice and Montanino, 2003) in its major part by three considerations, referring back to the table for data: (i) first of all, and most importantly, growth proved definitely remarkable, compared to the first years of the decade; (ii) second, the sharp downward pressure of interest rates in the middle of the nineties significantly contributed to reduce the interest charges even at the end of decade, by a dragging effect[26]; (iii) third, and finally, in year 2000 extraordinary revenues from selling UMTS licences helped reducing the EMU overall deficit of an outstanding 1%/1.1% of GDP.

However, as it can be shown by the trend of the CAB (Cyclically-Adjusted Balance), in 1999 the budgetary recovery process had already stopped: as a matter of fact in that year the cut in nominal deficit was far bigger than the one in the CAB and, in year 2000, for the first time, its value increased rather than decreased. Therefore, considering Euro area as a whole, the good economic cycle of years 1999 and 2000 was *not* exploited to reduce the structural deficit and, when the cyclical conditions in Spring 2001 started to deteriorate, also the nominal deficit started to increase. The result, as the table shows, is a quick passage from a +0.1% in 2000 to a – 1.6% in 2001, more effectively explained by the fall in the CAB from – 1.8% to – 2.1% in the same years. Consequently, a first finding seems to be that, from an aggregate point of view, the goal of the *"close to balance or in surplus"* rule[27] was reached in year 2000. However, following the observation of the CAB values, the circumstances were much more different; to put it with the clear words of Giudice and Montanino (2003): "While the nominal balances were even better than the expected, the structural positions were deteriorating".

[26] In addition, for highly indebted countries advantages were even more notable: Italy, for example, real interest rate fell from 8% to 5.9%, with of course an extremely positive effect on the public expenditure side.

[27] Here, the literal interpretation of the Pact's medium term objective, rather than the "minimal benchmark" one, is considered, following the European Commission's point of view; therefore a value of

Indeed, moving towards a country-by-country analysis, one could argue that the above generalisation has to be corrected, in some cases. As the table below suggest, in 2001, a complete fiscal consolidation was reached in eight countries of the EMU, with, conversely, the other states – Italy, France, Germany and Portugal – not having structurally adjusted their finances yet.

Table 2. National Budget Balances, (Years 2000-2001)

	Budget Balance (% of GDP), Excluding UMTS		*CAB*	
State	2000	2001	*2000*	*2001*
B	- 0.1	0.2	*- 1.1*	*- 0.4*
D	- 1.3	- 2.7	*- 1.6*	*- 2.5*
EL	- 0.8	- 0.4	*0.9*	*- 0.7*
E	- 0.4	0	*- 1.1*	*- 0.7*
F	- 1.3	- 1.5	*- 1.7*	*- 1.6*
IRL	4.5	1.7	*2.4*	*- 0.1*
I	- 1.7	- 1.4	*- 1.9*	*- 1.5*
L	5.8	5	*4.2*	*3.6*
NL	1.5	0.2	*- 1.1*	*- 0.3*
A	- 1.9	0.1	*- 2.5*	*- 0.2*
P	- 1.8	- 2.5	*- 2.6*	*- 3.2*
FIN	7	4.9	*4*	*3.6*

Source: European Commission, *Public Finances in EMU – 2002.*
Data from *Table I.2*, page 11. *(Spring 2002 Forecast).*

– 0.5% represents the correct *close* to balance target (European Commission, *Public Finances in EMU – 2002)*.

Trying to recap, focusing on the aggregate point of view and regarding years from 1998 to 2001, one could say that during the first two years of life, the SGP has been working in a very positive way, showing that fiscal consolidation did not come to a halt after the successful convergence process ended in 1997 and appearing a suitable framework for ensuring budget discipline in EMU (Cabral, 2001).

Nevertheless, years 2000 and 2001 were a sort of *lost occasion* to consolidate Public Finances in a structural way and to make room for automatic stabilisers to work properly, as soon as the cycle would have stopped to help policymakers hitting the Stability Programmes' targets.

2.4.2 Years 2001-2003

During the two following years, Public Balances' positions continued to deteriorate, driven by the significant downturn in the global economy, as GDP growth values from Table 3 below may witness. The nominal deficit in the Euro area jumped from –2.3% of GDP in 2002 towards – 2.8% in the 2003, the highest value since 1996, when the deficit recorded was – 4.6%. In addition, the Debt ratio increased, for the first time in many years, to 70.4%.

At first sight, this outcome does not seem completely negative, considering the background of slow growth: as a matter of fact, the overall development in nominal terms can be largely explained by the working of automatic stabilisers (European Commission, 2003a). Indeed, the 0.6% deterioration of the actual balance in 2003, compared to 2002, shows a cyclical component accounting for 0.7 of a percentage point of GDP (European Commission, 2003c) and therefore largely explains the working of the automatic stabilisers in producing such result.

Table 3. Growth and Budgetary Positions in EMU (Years 2002 – 2003)

Year	Balance (% of GDP) *Net borrowing (-) or Net Lending (+)*	Structural Deficit (CAB)	Debt Stock (% of GDP)	Real GDP Growth Rate
2002	- 2.3	- 2.3	69.0	0.9
2003	- 2.8	- 2.3	70.4	0.4

Source: European Commission, *"Autumn 2003 Economic Forecasts"*.
Data from *Table 2.10*, page 39.

Moreover, considering the unfavourable trend of the CAB during previous years, it is not surprising to view a stall in the structural development, between years 2002 and 2003, with the consequence being, of course, a standstill in the overall budgetary consolidation process. Again, recalling the assessment of the results of years 1998 – 2001 above, the uncompleteness of the fiscal consolidation process during years 2000 and 2001 has to be accused, together with the adverse business cycle, as the main responsible for this kind of development in Public Finances.

On the other hand, the outcome of the Euro area as a whole is the result of striking contrasts in budgetary performances between Member States: examining Table 4 below, among the twelve members of the EMU only four – Belgium, Luxembourg, Spain and Finland – showed positions *close to balance or in surplus* in year 2003.

In addition, as we highlighted in the last paragraph in a more qualitative way, the budgetary positions of Germany, France, Portugal and Italy appear very weak, with deficits in year 2003 ranging from – 2.3% of GDP in Italy to – 3.7% in France and, above all, in the case of Germany, France and Portugal, largely exceeding the 3% "upper ceiling".

In this context, the *Excessive Deficit Procedure* was applied – although not fully – following the Commission's *Early Warnings,* between years 2002 and 2003, to Portugal, France and Germany, with all the consequences that we recalled in the previous paragraphs.

Table 4. National Budget Balances, (Years 2002-2003)

	Budget Balance (% of GDP), Excluding UMTS		*CAB*	
State	2002	2003	*2002*	*2003*
B	0.1	- 0.2	*0.1*	*0.2*
D	- 3.6	- 3.4	*- 3.3*	*- 2.6*
EL	- 1.2	- 1.1	*- 1.8*	*- 1.8*
E	- 0.1	- 0.4	*- 0.4*	*- 0.4*
F	- 3.1	- 3.7	*- 3.3*	*- 3.5*
IRL	- 0.3	- 0.6	*- 0.9*	*- 0.3*
I	- 2.3	- 2.3	*- 2.1*	*- 1.8*
L	2.6	- 0.2	*2.0*	*0.5*
NL	- 1.1	- 1.6	*-1.0*	*- 0.4*
A	- 0.6	- 1.1	*- 0.6*	*- 1.0*
P	- 2.7	- 3.5	*- 2.5*	*- 2.6*
FIN	4.7	3.3	*4.8*	*3.7*

Source: European Commission, *Public Finances in EMU – 2003.*
Data From *Table I.2*, page 5 *(Spring 2003 Economic Forecasts).*

2.5 Conclusive issues

At this point, having examined some key data from Member States and EMU as a whole and having in mind what sort of outcomes followed these years, we can underline a few facts:

- In its very first years of life, the SGP showed itself, *ex post*, as a good *one-size-fits-all* framework for ensuring budgetary discipline among the EMU Members. Significant results in the years 1998 and 1999 were achieved, confirming a pleasant path towards the adjustment of European Public Finances.

- During the following years, the Euro area as a whole – but notably some of its Members – failed to make progress towards the *close to balance or in surplus* position. This failure, indeed, may be largely explained by: (i) the downturn in the global economy and, (ii) most importantly, the weakness of the structural action in "good times".

- Even when the budgetary difficulties started to emerge, in years 2000 and 2001, the *Early Warning* procedure did not succeed in inducing the Member States to perform virtuous behaviours. This, in turn, may be explained (Giudice and Montanino, 2003) by the absence of political willingness not only of the States addressed by the procedure but also of the others, unable to exert a successful political pressure.

- Finally, the experience of France and Germany showed[28] how strong are the incentives to find alternative *political* solutions, contributing to undermine the credibility of the overall system of rules. The case of Portugal and Italy, on the other hand, showed the extensive use of one-off measures, undermining the annual "quality" of Public Budgets, as well as the long-term structural adjustment process.

[28] We refer back to previous paragraphs for an analysis of the recent developments in France and Germany's situations.

3 Testing the SGP

3.1 Introduction

This chapter is designed to move from last section's analytical description of the Pact and of its eventually troubled breaching towards a more normative approach, aimed at ultimately finding out what are the Pact's weak points and problems.

More specifically, the first part of the chapter is dedicated to an assessment of how the SGP behaves when compared to some ideal fiscal rules, most notably Kopits and Symanski's (1998), Iman's (1996) and Buiter's (2003) ones; the second one is instead intended as an insight into the main weaknesses and drawbacks that the Pact has showed so far. The aim is to eventually conclude on these topics and to provide a link towards next chapter, dealing with the main reform proposals.

3.2 The Pact and some Ideal Sets of Fiscal Rules

As Roel Beetsma (2001) argues*,* a good starting point of any kind of discussion regarding Fiscal Rules is probably that there is no *perfect* rule – that is one that has no disadvantages. However, before moving on towards the other topics of the chapter, it seems appropriate to provide a quick testing of the SGP with regards to an ideal set of rules and to make a first, theoretical assessment of the results.

Three criteria are considered below: (i) the Kopits and Symanski (1998), (ii) the Inman (1996) and (iii) the Buiter (2003) ones.

(i) The Kopits and Symanski criterion was originally devised to assess the quality of domestic fiscal rules; however, the parameters upon which it is based seem suitable also in the multinational context of the SGP. This feature of the Pact, however, will be taken into account when presenting the results of the *exam*. As shown in Table 5 below, the two authors provide a checklist of 8 ideal features against which the quality of fiscal rules should be assessed, as well as a subjective judgement of the EU ones[29].

Table 5. The EU Fiscal Rules against Kopits-Symansky' s criteria

Ideal Fiscal Rule	EU Fiscal Rules
1. Well-Defined	++
2. Transparent	++
3. Simple	+++
4. Flexible	++
5. Adequate Relative to Final Goal	++
6. Enforceable	+
7. Consistent	++
8. Underpinned by Structural Reforms	+

Legend: +++, very good; ++, good; +, fair;

Source: Buti, Eijffinger and Franco (2003), *page 4*.

1. Being *well-defined* is of course a key point for the rules' effective enforcement. However, although the SGP specifies when escape clauses may be invoked (cyclical factors, mainly), elements of ambiguity remain. First, it is not specified correctly how close to the ceiling the deficit should remain without being considered *excessive,* second, the *close to balance or in surplus* target remains vague and, third, it is silent on how to apply the Excessive Deficit Procedure in the case of violation of the criterion requiring the Debt Ratio to decline towards 60% of GDP, as long as it remains above such value.

2. The Pact shows only an medium degree of *transparency*, with a number of uncertainties remaining and being clarified only gradually, appearing weak especially in the field of the definition of general government units and decisions regarding new

[29] See also Kopits (2001).

accounting operations introduced by Member States. In conclusion, judgmental elements are implied when assessing accrual data (Balassone, Franco and Zotteri, 2002).
3. *Simplicity* is the strongest point in favour of EU Rules: they are simple to evaluate, easy to grasp by the public opinion and have enjoyed, during years, high visibility (Buti, Eijffinger and Franco, 2003).
4. *Flexibility* cannot of course be high, considering the *simplicity-flexibility* trade-off. To put it with the words of Paul De Grauwe[30]: "It is fair to say that the Stability Pact is quite unbalanced in stressing the need for strict rules at the expense of flexibility"; however, the practical application of the rules has shown, *ex post*, a higher than expected degree of flexibility (Giudice and Montanino, 2003).
5. The rules seem *adequate* to ensure budgetary discipline and to extend their influence on the medium-long run, even if some doubts remain regarding peripheral countries, having large public investment needs which may be difficult to reconcile with mantaining broadly balanced budgets. The reference, of course, is to the EU Enlargement Process that, concerning this issue, may become even more problematic than already is.
6. *Enforceability* is quite a critical issue[31], in particular after the November 25, 2003 decision by the council to suspend the sanctioning mechanism for France and Germany. As a matter of fact, if Buti, Eijffinger and Franco (2003) speak about "the risk of a partisan application of the rules", regarding the implementation of sanctions, one could argue that such a risk is now reality; therefore, one may comment that the preventive "menace system" is not able to discipline governments in an appropriate way and that

[30] From "Economics of Monetary Integration" (2000), Chapter 9 *(Fiscal Policies in Monetary Unions)*, page 211.
[31] A quick insight on the topic by Paul De Grauwe (2000) seems interesting: experience with Fiscal Rules suggests that in general "it is very difficult to enforce them. An example of such difficulties may be the Gramm-Rudman legislation in the USA. In 1986, the US Congress approved a bill that set out explicit targets for the US Federal Budget Deficit. If these targets were not met, spending would automatically be cut across the board by a given percentage so as to meet the target. It can now be said that this approach with rules was not very successful. The US executive branch found all kinds of ways of circumventing this legislation. For example, some spending items were put 'off the budget'.
There is also evidence collected by Von Hagen (1991) for American States pointing in the same direction. Von Hagen found that those states that had constitutional limits on their budgets deficits or on the level of their debt had frequent recourse to the technique of 'off-budgeting'. As a result, he found that the existence of constitutional rules had very little impact on the size of the states' budget deficits.

the ultimate reason, to a certain extent, is the *last word* expressed by the Council, a political – and therefore *per se* not independent – judge.

7. Being internally *consistent* and consistent with other policies is the goal of a good fiscal rule; indeed, the EU rules express some contradictions: between counter-cyclical action and safeguarding the deficit *upper ceiling*; between integration of fiscal surveillance at the European Level and national budgetary decisions; and so on. Therefore, this feature remains quite ambiguous and calls for being prudent when discussing it.

8. Finally, given the increasing attention paid to composition and long term sustainability of Stability Programmes, the SGP is more likely to be underpinned by *tax and spending reforms* necessary to reinforce fiscal prudence. However, such reforms remain outside the core of the SGP and no sanctions are foreseen in the case of violation of the commitments on the "quality" of the Stability Programmes (Buti, Eijffinger and Franco, 2003) and therefore incentives towards *creative accounting* and the use of one-off measures show up (Giudice and Montanino, 2003).

In conclusion, adopting an overall perspective, the European Rules perform quite well, undeniably, with *Simplicity* being their strongest point and *Enforceability* and *Reform Inducing* the weakest. And the main reason is the environment in which the Pact's rules work: their multinational character of course deeply affect their design and implementation, and – inevitably and endogenously – weakens the overall architecture.

More precisely, following Buti, Eijffinger and Franco (2003), the necessity of respecting national sovereignty implies that the objective of being as neutral as possible, regarding socio-economic preferences, stands in contrast with the tendency of centralising – or at least coordinating, pursuing a certain degree of "harmonisation" of point of views – some key aspects affecting the role and size of the State in the Economy. In addition, given that a multitude of trade-offs affects the design of the Rules (notably, *simplicity-flexibility, simplicity-adequacy* and *flexibility-enforceability)*, the multinational character increases heterogeneity and dispersion of preferences with the consequence that a *one-size-fits-all* fiscal rule is likely to be sub-optimal[32].

[32] For a deeper focus on the issue, see Buti, Eijffinger and Franco (2003), pages 6 and 7.

(ii) The Inman's Criteria, on the other hand, concentrate on the analysis of a set of rules' ability in ensuring *compliance*. Basing on the analysis of US States, Inman (1996) indicates four main criteria for compliance: (a) timing for review, (b) overridding, (c) enforcement and (d) amendment.

a. An effective fiscal rule is based on *ex post*, rather than *ex ante*, deficit accounting; indeed, the SGP performs well against this criterion, being based on an *ex post* analysis of the States' *realised* fiscal performance. Inman, therefore, considers the fiscal rule "strong"[33].
b. A powerful fiscal rule cannot be *overridden* or *temporarily suspended*: Inman defines the SGP system of rules as "strong", since overridding by majority voting is not allowed. Again, as underlined in many cases above, after the events of November and December 2003, the situation has broadly changed, calling for defining them "weak".
c. Rules have to be *enforced* by an open, politically independent and non-partisan review panel or court: in the case of EU rules the same ministers of finance who are responsible for drafting national budgets also have to decide whether they breach the Pact. Straightforwardly, *enforcement* is "weak".
d. *Amendment* is, at first sight, difficult and costly, as it would require unanimity among the Members of EMU[34]; however, even in this case the considerations of point *b* apply and therefore ask for a "weak" mark.

In conclusion, regarding Inman's Criteria, it seems that the multinational feature of the Pact's rules affect their strength in a deep way – recalling the result in the Kopits-Somanski case. Indeed, considering the multi-country set of rules, rather than a federal government with sanctioning powers, the stress on reputational consequences of

[33] See Buti, Eijffinger and Franco (2003), and also Amtenbrink (1997), to have a more precise idea of the logic of Inman's testing of EU Rules.
[34] More precisely, to modify the interpretation of the *close to balance or in surplus* rule only the majority of finance ministers would be required. This, in turn, implies an even further weakness of the rules.

unvirtuos behaviours plainly loosens "compliance-punishment binomial", as well as weakening the entire sharpness of the system.

(iii) Finally, Buiter (2003) has elaborated a judgement criterion centred on "Ten Commandments for a Fiscal Rule", as the title of his paper on the issue suggests.

According to such Commandments, the Rule should be: 1. simple, 2. able to ensure the solvency of the State, 3. referring to the consolidated accounts of the public administration and central bank, 4. neutral regarding the dimension of the public sector, 5. not implying a pro-cyclical behaviour of the Fiscal Policy, 6. consistent with long run objectives, 7. able to allow different behaviours to different Sates with different initial Economic and Social conditions, 8. sensitive for the European Union as a whole, 9. credible, 10. applied in an independent and non-partisan way.

The author's assessment reveals that only points 1 and 2 are fully met and point 4 only partially. In addition, point 5 would be met only if budgetary positions ensuring enough room for manoeuvring in all kind of cyclical conditions were reached, even if some doubts about the high costs of adjustment to reach the goal remain.

Buiter's conclusion – quite strict, indeed – is that the European Fiscal Rules are "excessively rigid and not consistent with long-run objectives". More precisely, this result comes out after the review of two other sets of rules, the UK 'Golden Rule' for investment financing and its augmented version for the so-called 'permanent balanced budget': the main finding of the author is, eventually, that the Pact is the weakest among them.

Trying to conclude on the paragraph, the main finding, either in the Kopits-Symanski or in the Inman case, seems to be that *supra-nationality* is the critical element of the entire construction, and that, allowing for this "structural" weakness, the overall performance against all the criteria remains acceptable if not satisfying.

Buiter, on the other hand, focuses his diagnosis more on specific topics, finding a high degree of weakness in the field of flexibility and long-term vision; one could argue, therefore, that in this case the accent is put on single, endogenous weaknesses rather than on the rules' multinational framework, as the two criteria above do.

Again, therefore, the analysis of Pact's theoretical *grandeur* divides many authors in a wide range of points of views, from the sharpest prosecutors to the more tender admirers; indeed, it seems fair to adopt a "minimal platform" perspective, focusing on some specific problems of the SGP rather than on its overall *raison d' etre*.
Consequently, one could argue that some controversies emerging from the Pact's analysis should be underlined and further addressed:

- The main quality of the EU fiscal rules, *simplicity*, of course generates relevant problems in the fields of *rigidity* and *short-terminism*. This, in turn, may create significant controversies both in a short-run downturn scenario and in a long-run, strategic one. Indeed, it seems fair to admit that a cure for these two main pathologies has to be found with effective, unbiased interventions.

- The multi-nationality of the Pact's Rules has always to be kept in mind, when addressing its weaknesses: considering the nowadays' level of political integration, some clear *pareto-inefficiencies* have to be tolerated, if one considers the SGP by a looser set of requirements, justified by its supra-nationality nature.

3.3 Critical Issues concerning the SGP

> "Michael Mussa [*a famous monetary economist*] is fond of describing how, each time he walks to the IMF cafeteria, down the corridor where the currency notes of the member states are arrayed, he rediscovers one of the most robust regularities of economics: the one-to-one correspondence between countries and currencies". *Barry Eichengreen*[35]
>
> "The asymmetry between Monetary and Fiscal Policies [*in EMU*] is a fault of design which will sooner or later lead to tensions between policy areas and member States". *Sixten Korkman*[36]

35 From "European Monetary Unification – Theory, Practice and Analysis", *Chapter 10 – "A More Perfect Union?",* page 256.

This paragraph pursues the delicate aim of addressing the problems that have emerged – and that are continuing to develop – from the SGP during its first implementation years. The structure is analytical and centred on the main criticisms that are often expressed against some of the Pact's features; an insight into each specific issue is provided, with, eventually, the objective being to find out the most relevant aspects of each one and to outline a sort of ranking among the hottest topics.
The order of presentation of the subjects is the following one:

1. Budgetary Flexibility and Functional Symmetry;
2. Disincentives towards Public Investments;
3. "Short Terminism" and the "Quality" of Public Accounts;
4. The European Aggregate Fiscal Stance and the Enlargement Process;

3.3.1 Budgetary Flexibility and Functional Symmetry

The list of the Pact's weaknesses could not have started with another issue, considering the huge controversy developed on the topic as a consequence to the troubled events of November and December 2003.
However, given that such kind of problems have been undermining the Pact's effectiveness since its early life, the events above may be considered as a mere *casus belli* and such controversial topics seem to require a thorough assessment, first on a theoretical and then on an empirical basis.
At this point, it seems that recalling some findings from literature on Optimum Currency Areas, following among others Kenen (1969) and De Grauwe (2000), may help at introducing an assessment of the issue, at least from a theoretical perspective.
First of all, a well-known, traditional policy guideline is that it is desirable to concentrate a significant part of the national budgets at a central level[37], as it allows: (i) countries to enjoy automatic transfers, if hit by asymmetric shocks; (ii) to cope, in the specific case of

[36] From "Fiscal Policy coordination beyond the SGP?", in *"The Stability and Growth Pact – The Architecture of Fiscal Policy in EMU"*, by Brunila A. and others, Palgrave; page 306.
[37] For a significant guideline on the design of a centralised system see for example the Mac Dougall Report (1977).

EMU, with the proved inability (Fatàs, 1998) of regional automatic stabilisers – i.e. labour mobility and relative price flexibility, typically – in absorbing such shocks.
Thus, to put it with the clear words of Obstfeld and Peri: "the key insurance mechanism [*given that the two regional adjustment mechanism above are too weak in Europe*] in a Monetary Union is based on interregional transfer payments mediated by the central government".

Second, if such centralisation of the national government budgets in a Monetary Union is not possible, as the European context seems to witness, national fiscal policies should be used in a *flexible* way (De Grauwe, 2000). Therefore, when countries are hit by negative shocks, they should be allowed to let their budget deficit increase through the movements of automatic stabilisers, and they should be given a substantial degree of autonomy for their discretionary manoeuvring.

Indeed, the entire logic of the issue is based on the fact that countries lose two instruments of policy – the exchange rate and monetary policy – when joining a Monetary Union and that, consequently, if there is no centralised budget automatically redistributing income, the country-specific shocks cannot be successfully absorbed.

On the other hand, the "dark side" of the matter is of course that such flexibility may create incentives towards issuing too much debt and therefore, in the context of Monetary Union with a monetary authority able to commit itself regarding price stability, as the ECB is, some *free-rider* problems are likely to emerge[38].

In conclusion, if *the carrot* is Budgetary Flexibility, *the stick* has to be some sort of Rule preventing Member States from pursuing unvirtuous fiscal behaviours.

Moreover, coming back to the analysis of the European Rules, the 3% "hard ceiling" on national budgets definitely tightens the *amount* of flexibility each state possesses to cope with asymmetric shocks. Consequently, as soon as cyclical conditions (and political willingness) allow it, a quick transition towards broadly balanced budgets in structural terms is required, in order to create sufficient room for manoeuvre.

But, straightforwardly, which *kind* of manoeuvre has to be undertaken and implemented, given that some sort of action has to be taken? Before moving on, Box 1 below provides a quick insight into the "Fiscal Activism *versus* Automatic Stabilisation" *dilemma*.

Box 1. ***Discretionary Fiscal Policy or Automatic Stabilisation?***

The question, at the moment, is whether discretionary fiscal action has to be adopted to *fine-tune* the business cycle or put aside in favour of automatic stabilisation. The aim is to find out whether a strong case to claim "room" for automatic stabilisation to take place, in the European context, may be found or not.
Following the line of thought of European Commission (2002), ECB (2002) and Buti and Van den Noord (2003), it seems that a widespread theoretical scepticism, as well as some empirical results confirming it, create a relevant case *against* using discretionary fiscal policies to act counter-cyclically.

The main lines of criticisms are the following ones (European Commission, 2002):

1. Discretionary policies entail large fiscal lags (both information and implementation ones).
2. They are difficult to reverse and likely to have adverse supply-side developments in the medium-long run.
3. Policy failures increasing the cycle's swings, rather than dampening them, have been frequent in the past, due to the choice of both wrong measures and wrong timing (Buti, Van den Noord, 2003).
4. Discretionary Fiscal policies are subject, like monetary policies, to *time inconsistency* (i.e. the temptation to announce one kind of policy and follow another one); nevertheless, the solution that has been found to cope with such problem in the monetary context – relying on a strong, independent authority, the Central Bank – cannot of course be applied in the fiscal, decentralised environment.

In addition, considering this set of criticisms, a rule-based fiscal policy relying on the working of automatic stabilisers provides several advantages. First of all the impact lag of automatic stabilisers is generally considered to be relatively short and, consequently, the behaviour of the actual budget balance is *always* counter-cyclical. On the other hand, as Buti and Van den Noord (2003) underline and prove *via* their econometric analyses, the "political business cycle" in Europe is "alive and kicking", with the consequence being of course the utilisation of fiscal policy in a pro-cyclical way; clearly, automatic stabilisation carries the advantage of working on a separate field, more like an autonomous – and therefore usually unbiased – adjustment mechanism.

On the other hand, many economists claim the importance of relying on discretionary policies, even taking account of their proved weaknesses, considering the policy *vacuum* after the losing of the monetary instrument at the national level. Brunetta and Tria (2003), for example, have argued that a fiscal action limited in its entity and, most importantly, in its time is likely to produce the *traditional* effects on the aggregate demand and that if its implementation lags and its *dynamic incoherence* problems could be eliminated, the fiscal policy would be "more desirable, as it would be effective". *(continued)*

[38] See for example Chiari and Kehoe (1998).

Moreover, to cope with the problems above, the two authors propose, following Wyplosz (2002), to set up an Independent Fiscal Authority able to perform an unbiased policy action, above the traditional institutional mechanisms.
Nevertheless, it seems that (i) in the context of the *nowadays'* management of *national* Fiscal Policy and (ii) within a European Context *not yet* ready to significantly improve the *aggregate* Fiscal action on whatever basis (Central Budget, Independent Fiscal Policy Committee, and so on), the rule-based fiscal policy, rather than fiscal activism, would be a more sound policy approach towards implementing the counter cyclical action.

However, and in conclusion, two issues have to be further addressed: (i) the real feasibility in getting budgetary positions *close to balance or in surplus*, as a necessary pre-condition for automatic stabilisation to work properly; (ii) the *degree* of cyclical smoothing that can be attained by the automatic stabilisers.
Anyway, for an insight into the *strength* of Automatic Stabilisation, we refer back to next chapter, where proposals to improve the Automatic Stabilisers' effectiveness will be addressed.

Indeed, it seems that the problem of Flexibility turns into an even more controversial one, as it actually implies the *necessity* of following a fiscal adjustment "path" leading towards a set of conditions able to allow flexibility itself being exploited. More precisely, if the good conditions of the economic cycle are not fully exploited to gain strong budgetary positions, in structural terms, the degree of flexibility in the case of downturn would be limited, if not missing.
From a theoretical point of view, in addition, Buti and Martinot (2000) confirm that there is nothing in the SGP preventing countries from undertaking (i) pro-cyclical expenditure increases and/or (ii) tax reductions during periods of strong growth. Thus, the consequential result is that significant failures in the ability of acting counter-cyclically are likely to turn up in the least appropriate moments – those of a downturn in the economy.
At this point, some empirical evidence may help in explaining the topic: following the considerations of Buti and Giudice (2002) and the analyses of Buti and Sapir (2002), one could say that the asymmetric nature of the SGP had been already apparent in year

2000[39] by the fact that when the economic condition was buoyant, fiscal consolidation was not pursued by governments (notably Germany, France and Italy), who relied on one-off measures to meet the Stability Programmes' targets and were not too much concerned on how to provide full coverage to their tax cuts. The result was, of course, a waste of an occasion that would have led, in the following years, to the breaching of the 3% threshold (in the case of France and Germany) as well as of the Pacts' overall architecture.

A brief conclusion, at the moment, is likely to be that:

- As the EMU cannot rely on a Central Budget of relevant dimension[40] able to cope with country-specific shocks, another "instrument" has to be found to ensure a certain room to cope with asymmetric shocks.
- Given that "The Pact would be flexible enough to accommodate the automatic counter-cyclical component of national fiscal policies if member states bring their structural deficits close to balance"[41], the combined presence of the *close to balance or in surplus* objective and of the lack of incentives towards fiscal virtuosity in "good times", as the evidence from recent years may prove, creates a fragile policy framework in which the Pact's proved asymmetric nature *de facto* reinforces its rigidity.

---

[39] See also paragraph 2 for data on developments in EU Public Finances.

[40] At the moment, the upper ceiling for Central Budget is 1.27% of European GDP, and no resources of the nowadays' approximately 1% of GDP budget are destined to any kind of counter-cyclical action; as a matter of fact, huge amounts of money are currently absorbed by the CAP (Common Agricultural Policy) and the rest is, roughly, equally distributed among the "Structural Funds" and the "Social and Cohesion" Ones, aimed at counter-balancing some 'structural' discrepancies between the weakest and strongest Member States. Moreover, following the setting up of the so-called "Lisbon Strategy", which is aimed at transforming the European Union into the "most competitive knowledge-based economy in the world by 2010", some proposals by the Commission have turned up in the first months of 2004 to re-design the structure of EU Budget following a more *growth oriented* vision. However, at the moment, and till 2006 – the last year of such a structure in the Budget, if not reconfirmed -, nothing apart such proposals have concretely emerged.

[41] From Canzonieri and Diba, *"The SGP: Delicate Balance or albatross?",* in Brunila A. et al*.,* page 54, "The SGP – The architecture of Fiscal Policy in EMU", Palgrave.

3.3.2 Disincentives towards Public Investments

Both the Maastrich Treaty and the SGP concentrate fiscal surveillance on the values of deficits and debt stocks, allowing Member States to freely define the composition of either revenues or expenditures. Therefore, in the same framework of fiscal rules live very different States, regarding the definition of their Social Preferences and, consequently, the configuration of their Budgets.

In this composite context, as Giudice and Montanino (2003) suggest, a simple consideration may be that within the Pact's framework, a State with relatively high Public Investments and a deficit slightly exceeding the 3% threshold would be sanctioned, while another one with low Investments and a deficit a little under the "upper ceiling" would not.

Therefore, the absence – at least regarding the formal meeting of the Stability Programmes' targets, if not of the requests from the Commission in this field – of an assessment of the expenditures' composition implies that the worrying "3% constraint" will tend to dominate the policy decisions on the expenditure side.

Consequently, and more precisely, if one adopts the perspective of a Member State, it happens that, given the Pact's concern of maintaining broadly balanced budgets, capital expenditure would have to be funded from current revenues, rather than by debt issue. Thus, the traditional logic of investment financing – that is spreading the cost of an investment project over all the generations of taxpayers who benefit from it – is weakened, if not put aside.

Two implications (Balassone and Franco, 2000) follow the considerations above: (i) first of all, a disincentive arises[42] towards undertaking large projects, producing deferred benefits and entailing a significant gap between current revenues and current expenditures; (ii) secondly, such a disincentive becomes stronger during fiscal consolidations, as largely shared views from literature (for example, Oxley and Martin,

[42] See also Balassone and Franco (1999) for a detailed analysis of the topic and results from a two-period model involving a policy maker's behaviour analysis.

1991) suggest[43]. Furthermore, to emphasize the relevance of these issues one may cite the words of Perotti (1996), who says that "as cuts in public employment and transfer programs are politically much more costly than, say, *capital* spending cuts, perhaps only governments that are determined to carry out a lasting consolidation undertake them"; again, the governments' temptation to cut capital rather than current expenditure appears irresistible, notably during the politically difficult years of fiscal consolidation.

A confirm to such a point of view may also appear from the empirical evidence collected by the European Commission (2000) and recalled by Buti and Giudice (2002).

First of all – as explained in detail in Box 2 below – both argue that the 1993-2000 Fiscal consolidation process among EMU Members was based, in vast majority, on a sort of *switching strategy*[44], from a revenue-based retrenchment (years 1992 and 1993) to an expenditure-based one (years 1994 to 2000)[45].

Box 2. **Composition of Fiscal Adjustment in Years 1993-2000**

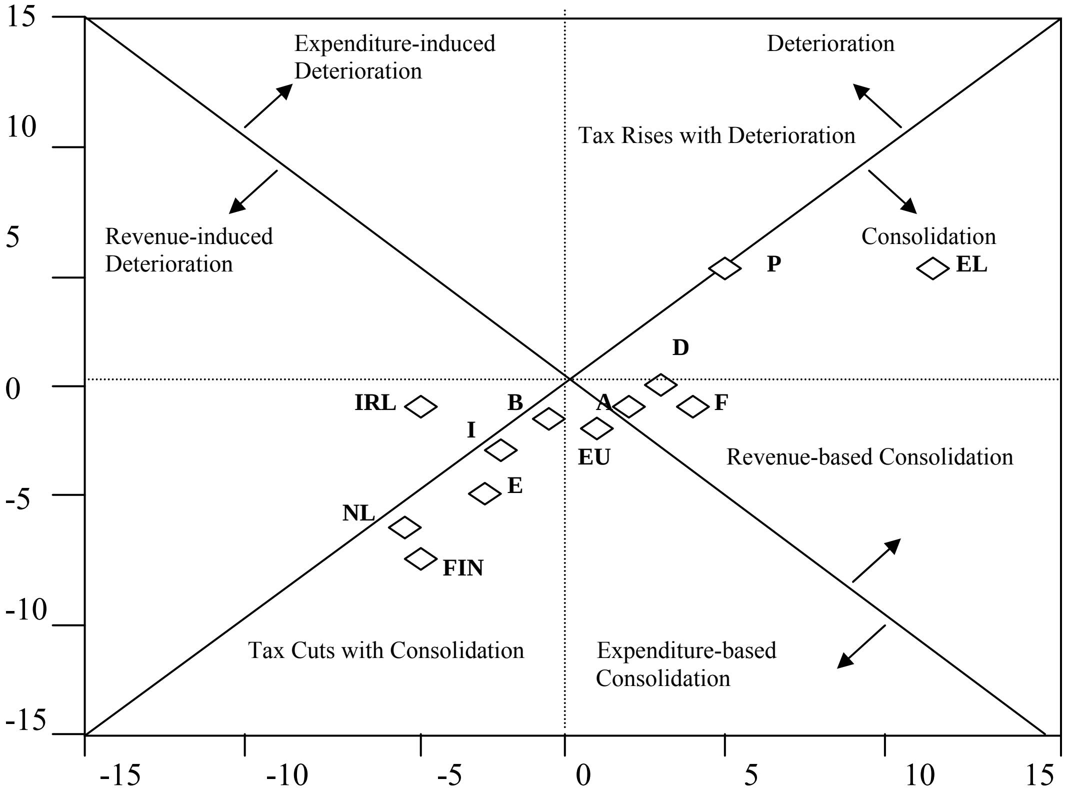
In the context of the above-mentioned *switching strategy,* the Graph 2 below (*see next page for the legend*) may help in making a synthetic assessment of the budgetary adjustment process, to show the prominence of expenditure cuts over revenue increases. It is based on a decomposition of the discretionary policy changes for individual EU countries over the period 1993-2000 into changes of total revenue and in primary expenditure. The diagonal from top right to bottom left indicates the direction of the budgetary adjustment: the area above it marks deterioration in the CAPB (Cyclically-Adjusted Primary Balance), while the one below indicates a structural consolidation. The diagonal from top left to bottom right, instead, marks the composition of the adjustment, signalling whether revenue or expenditure changes prevail. As shown in the graph, practically all countries lie *below* the top right-bottom left diagonal, meaning that their CAPB improved during the period. In addition, regarding composition, only Portugal and Greece pursued a revenue-based retrenchment and several countries combined discretionary cuts in spending with a reduction in tax revenue, thus reducing the overall size of the public sector.

---

[43] This consideration from Oxley and Martin (1991), page 161, appears convincing: considering political reality, "it is definitely easier to cut back or postpone investment spending than it is to cut current expenditure".

[44] See " Public Finances in EMU – 2000".

Graph 3. Composition of Fiscal Adjustment, 1993-2000, in points of GDP



Legend:

'X' axis: Change in *cyclically-adjusted* total revenue.

'Y' axis: Change in *cyclically-adjusted* total revenue.

Source: Buti and Giudice (2002), page 9.

In addition, as the data on Public Investments may witness (European Commission, 2002), the tendency to cut capital expenditure turned up in most European countries during the years 1994-2000, following the incentive cited above by Balassone and Franco. As a matter of fact, Public Investments, which have continued to be on a

45 Von Hagen et al. (2001), in addition, commented that this had not been a deliberate strategy, as countries were forced to move towards expenditure cuts by the substantial failure of the revenue-based retrenchment.

downward path since mid-1970s, fell as a share of GDP from 4% in 1975 to less than 2.5% in 1998 and, in particular, they were reduced by a remarkable 0.8 percentage points of GDP in the period 1993-1997, accounting for around one fifth of the total correction of public spending during the same period.

In conclusion, together with having verified the good quality (Buti and Giudice, 2002) of the fiscal adjustment, the widespread tendency towards the expenditure-based consolidation implies some clear findings as well as confirms to the considerations above:

- First of all, Public Expenditures in Europe have significantly reduced over time[46]; moreover, under the Pact's "pressure" and *via* the above-mentioned *switching strategy*, as data may confirm, that tendency has been strengthening in recent years.

- Secondly, the perverse incentive examined above by Balassone and Franco towards lowering the *capital* rather than the *current* expenditure has turned up, *via* the less costly political "losses" arising from this kind of cuts. The aggregate fall of 0.8% of GDP in Public Investments, during years 1993-1997, definitely explains the dimension of the phenomenon.

- Finally, the presence of the *close to balance or in surplus* rule, together with the set of incentives cited above, means that a sub-optimal amount of Public Investments would be eventually financed and that, therefore, one should expect some sort of long-run negative repercussions on the potential growth rate of the economy.

---

[46] Indeed, given that the vast majority of Economists and opinion-makers endorse such positions, somebody, notably Gali and Perotti (2003), have argued that the decline in Public Investments had already started in the early 70ies, and, most importantly, had followed a trend common to all industrialised economies – USA, first of all. As the two authors argue, this, in turn, may be explained by two causes: (i) the high levels of economic development and the consequent link between public and private investments and (ii) the way of accounting PPPs, which may not be registered in the national public administrations' accounts because of their 'mixed' nature (Turrini, 2003).

3.3.3 'Short-Terminism' and the 'Quality' of Public Accounts

It seems fair to admit that the SGP focuses almost exclusively on short term objectives for the annual budget deficit, with no direct concern on the debt's trend; indeed, such a circumstance implies, first of all, that the overall European fiscal surveillance mechanism tends to focus more on short term outcomes than on long term ones, and, secondly, that it will tend to treat *in the same way* countries with *different* medium and long term prospects and different debt levels.

These plain considerations, in turn, carry some implications: following Buti, Eijffinger and Franco (2003), one may say that (i) incentives towards creative accounting and one-off measures come up and (ii) that the Pact may prevent countries from implementing policies – such as pension or labour reforms – which improve sustainability over the medium-long run at the price of short term's conditions worsening.

(i) Regarding the first issue, Eichengreen and Wyplosz (1998) and Kopits and Craig (1998) have found that the exploitation of creative accounting and one-off measures may be induced by the presence itself of a numerical rule – as the 3% ceiling is; the main reason, in turn, of this kind of incentive has to be found in the aim of avoiding *in extremis* the reputational costs of either the *early warnings* or the sanctions under the Excessive Deficit Procedure.

Besides, as Giudice and Montanino (2003) underline, since the 3% constraint has to be respected every year and, often, due to adverse condition in the economic cycle, a significant risk of breaching the "ceiling" may turn up for a *limited* period of time (i.e. an year only), the advantage of employing one-off or even "financial engineering" measures appears in a plain way. It is interesting to show that, in this case, the advantage of such measures is actually double, as not only they prevent the country from being sanctioned, but also they help coping with temporary disequilibria on the balance without negatively affecting the demand's components. Moreover, as the example of the UMTS extraordinary revenues in years 2000 and 2001 may witness[47], together with the potential advantages of such kind of measures, some inevitable costs have to be considered: first of

[47] See paragraph two for further details.

all, the fiscal adjustment in nominal terms appears illusory in structural ones, hiding the real conditions of Public Finances and making the structural consolidation even more costly, at the time it will have to be eventually implemented.

Furthermore, and finally, it seems intellectually honest to underline that the border between “good” and “bad” one-off measures is of course not well defined, and that if a *virtuous* utilisation of the same kind of measures may be justified in the case of sound public finances and of temporary negative conditions, of course a *free-rider* approach in a weak budgetary context has to be fiercely blamed. Once again, a discretionary assessment of single cases and circumstances has to be emphasized and may be considered as a sort of *second best* solution to such controversial problems.

(ii) Regarding the disincentives towards undertaking structural reforms, Eichengreen and Wyplosz (1998) have argued that Governments in the European framework tend to spend all their “political capital” in the field of budgetary adjustment, thus losing the necessary *consensus* required to implement structural reforms. Two considerations may further explain the two authors’ thesis: first of all, given the high degree of pressure from the EU boards to reduce deficit over time, the *endogenous*, national concern to keep budgets under control, by autonomously implementing structural reforms, is likely to reduce; secondly, as also Razin and Sadka (2003) underline, the *close to balance or in surplus* status implies that the costly (in the short-term, at least) structural reforms may be realized only if a relevant surplus has been previously accumulated.

In addition, Blanchard and Giavazzi (2002) have argued that the Pact’s tendency towards “Short-Terminism” finds its roots in the European *current* expenditure excess over the *capital* one and that, since no limits on current expenditures are set, the constraints on budget balances will risk inducing higher taxes, lower investments and less willingness to perform structural reforms. As an example, they provide the case of pensions’ reform: the passage towards private previdential schemes will imply lowering the current expenditure only in 5 to 10 years’ time; nevertheless, an immediate surge in the Public Balances’ costs is expected, to cope with diminishing contributions from workers and, at the same time, a standstill in the outflows to guarantee public pensions’ payments. Consequently, if one considers the difficulties Governments face in meeting the Stability Programmes’ targets, it is clear that a disincentive towards these costly policies will definitely turn up, although it is also clear that ignoring the long-run benefits because of the short-term costs is all but wise.

Furthermore, one may say that, to a certain extent, the problems related to financing large Public Investments, which we discussed above, are similar to those concerning the vast majority of structural reforms: whatever the ultimate aim of the deal, a project – or a reform – showing *immediate* costs and *deferred* revenues is likely to be discouraged by Pact's short term rigidity. Indeed, emphasising their common nature, such parallelism reaffirms the two issues' *joint* relevance and, consequently, calls for further tackling their perverse consequences.

In conclusion, it seems that the Pact's strong concern on current Deficit and Debt values is likely to imply overlooking the problem of the "Implicit Debt" (Brunetta and Tria, 2003) – such as, for example, either the one related to the future Pensions' funding or the long-lasting "burden" of inadequate infrastructures, lowering the potential growth rate of the economy. Therefore, this approach would eventually create a perverse tendency to postpone the solution of problems that nowadays do not harm the economic and political *equilibria*, but that, of course, in the long run will menace the overall system.

Concluding on the two topics, one may say that:

- The Pact's numerical rules, focusing on current values, create incentives towards exploiting one-off measures and towards focusing on short-term manoeuvring rather than on long-run *grand designing,* either in the field of Structural Reforms or of Capital Expenditure.

- Following a simple but effective guideline John Stuart Mill expressed in his *Principles of Political Economy*, dating back to 1848, one could argue that issuing debt is a choice that *"is often a necessary one, on the occurrence of extraordinary expenses or of a temporary failure in the ordinary sources of revenue"*. Following this approach, therefore, funding Structural Reforms as well as large Investment projects calls at least for rethinking the *close to balance or in surplus* dogma, together with finding some ways to tackle the set of perverse incentives induced by the Pact and examined above.

3.3.4 The European Aggregate Fiscal Stance and the Enlargement Process

Within the SGP framework of rules, each Member State remains individually responsible for its fiscal policies and thus only a timid attempt to coordinate the different budgetary adjustment strategies is pursued at a European level, but of course cannot be implemented as it could be done, say, in a Federal State.

Therefore, one may suggest that the simple aggregation of national policies may not result into an *optimal* fiscal stance at the Euro area level able, in turn, to ensure an adequate policy mix. It seems interesting to underline what Buti, Eijffinger and Franco (2003) say on the issue, signalling two endogenous weaknesses of the SGP rules. First of all, the rule-based policy coordination by the Pact is likely to be inadequate in coping with large, common shocks that would require a response coordinated by a single policymaker. Secondly, and conversely, even remaining within the limits of the Pact, an inappropriate fiscal stance may occur when a widespread policy action from many States would imply overshooting the objective at an aggregate level: for example, a shift from a surplus position to a balanced one in several countries, at the same time, may lead to over-expansionary fiscal stance, by the *spillover effects* between the States.

In addition, keeping in mind that from May 1st, 2004 ten new Members will join the European Union, the circumstances appear even more fragmented: as a matter of fact, on one hand the GDP per capita of the new members is far lower than the incumbents' one and, on the other one, the deficit levels are in vast majority higher than those of the "old" European Partners, even if accompanied by relatively lower Debts (Giudice and Montanino, 2003). Therefore, a *catching-up* process is expected in the forecoming years and, of course, the requirements of that group of countries – higher infrastructure investments, labour and pension reforms[48] – are likely to be far different compared to the

---

[48] Coricelli and Chada (1994) have even argued that the alignment process towards the European parameters could undermine the efforts by those states to undertake politically difficult structural reforms; therefore, the risk of a too strict application of the European rules to that group of states could carry on long run problems, together with high costs in terms of overall efficiency of the Economic system.

incumbents' ones. Again, the *one-size-fits-all* feature of the nowadays' European rules is likely to be sub-optimal, if not inappropriate.

Adopting this perspective, therefore, the line of thought of some economists and politicians to set aggregate targets for the Eurozone and then to *share* them among the Members calls, at least, for some sort of reflection. Given that, undoubtedly, large differences among Member States and their Governments' attitudes and social preferences are common in a European *scenario*, both the "old" and the "enlarged" one, a Communitarian approach would be perhaps more effective in coping with some fiscal controversies.

For example, setting a budgetary target for the Euro area as a whole could imply an improvement for the aggregate Fiscal Stance; however, choosing the appropriate mechanism to allocate deficit *shares*[49] or deficit *permits*[50] may become difficult, first of all from an institutional and then also from a political-bureaucratic perspective.

As a matter of fact, changes in the both the Treaty and the SGP would be required, and political willingness would have to be found to ensure them; however, as one could easily imagine, the risk of an institutional as well as political *vacuum* is more than concrete. Again, therefore, considering the current degree of Political Integration and that, as usual, it is a long way to from the *theoretical* level to *actual* policy, it seems more sensible to cope with these sets of problems on a different basis, leaving ambitious *Communitarian* visions to future, more mature moments in the life of the European Union.

---

49 Following the line of thought of the once French Finance Minister Dominique Strauss-Kahn, who presented his ideas at the informal EcoFin council in Dresden, in April 1999, an aggregate "euro area stability programme" made up on the basis of the national ones may be implemented and may allow the necessary flexibility required in specific cases. The idea is, basically, to apply the 3% budgetary target to the Euro area as a whole, permitting individual States to overshoot the constraints as long as other countries with deficits below that values balance their positions. *See next chapter for a deeper insight.*

50 The other mechanism, proposed by Casella (2001) would be that of a market allocation of deficit permits, rather than the political-bureaucratic one cited above. The idea would be similar but the way to implement it would be of course different: the system would be based on countries in deficit buying permits from the virtuous ones, thus ensuring an aggregate balanced outcome. *See next chapter for a deeper insight.*

3.4 A primary opinion on the Pact's Problems

Following the review of the most critical issues undermining the structure of the SGP, this paragraph tries to make an overall assessment to outline a sort of *report* on the Pact's main pathologies. The aim is to synthetically recollect the findings above, both to set the agenda of the main strategies to cope with them and to provide a link with the following chapter, centred on the Pact's reform proposals.

<u>1. Budgetary Flexibility</u>

Before moving on to the conclusions, two preliminary remarks seem appropriate.
First of all, given that, on one hand, the nowadays' European political climate does not seem to encourage further *Communitarian* achievements and, on the other one, no significant proposals have been implemented in the field of widening the European budget for stabilisation purposes, it seems that the solutions to the Pact's problems should have to be found *within* the current intergovernmental, fragmented *scenario*.
Secondly, the policy prescription that has been adopted, as the basis of this assessment, is that relying on *automatic stabilisation* rather than on *discretionary fiscal policy* to act anti-cyclically at the national level, may be highly useful to cope with the difficulties above, as it seems that an autonomous adjustment mechanism would be more suitable to smooth at least some of the controversies in the EU Policy Coordination context. Given these considerations, two main findings on the issue follow below.

The *first one* deals with the degree of Budgetary Flexibility allowed by the Pact, which has proved too weak to cope with the 2001/2003 downturn in the Global Economy, that may be considered as the first serious "test" on the issue. More specifically, given that the good performance of the Pact's early years disappeared as soon as the economic cycle ceased to *hide* its weaknesses, the main reason to explain such outcome has to be found in the failure to gain strong budgetary positions, in structural terms, at a national level. This, in turn, was the consequence of the Pact's asymmetric nature, which *de facto* acted as a further element of rigidity and created a difficult framework for counter cyclical action to be effective.

The *second one*, instead, is that the problem of Budgetary Flexibility has emerged, among all the Pact's weaknesses, as the most significant one. More specifically, besides showing predictable links with the other issues, it has appeared as a sort of crucial *bottleneck* to every kind of policy action having impacts on the public budgets.

Indeed, it seems that such interrelation among different problems has to be seriously considered, calling for an approach able to appraise – and then correct – the externalities existing between them.

2. <u>Disincentives towards Public Investments and the issue of 'Short-Terminism'</u>

One of the quite unexpected results from the analysis of this chapter has been that the set of incentives preventing countries from funding large Public Investments may be considered, to a certain extent, similar to the one restricting the Pact's vision to short term outcomes, thus limiting, if not compromising, a sound implementation of Structural Reforms. This common feature may in turn found its roots in the problems underlined above at point one: as a matter of fact, as both theoretical and empirical approaches have witnessed, the Pact's short-term rigidity has to be blamed as the main underlying cause to such perverse effects.

Indeed, it seems that attempts to internalise the externalities between, on one hand, Budgetary Flexibility and, on the other, Investment Financing and Structural Reforms planning have to be considered, in the light of the findings from these results.

3. <u>Aggregate Fiscal Stance and EU Enlargement</u>

With the European Union engaged in a complex enlargement process and with differences among, first of all, the "old" Members' fiscal behaviour getting wider and wider, it will soon become highly desirable to find some ways to direct some aspects of the management of Fiscal Policies at a central level. However, it seems that taking into account, on one hand, the problems at points one and two above, and, on the other one, the Institutional and Political context in the nowadays' Europe, a more prudent approach should be taken and, therefore, that this weakness should be for the moment put aside, even if not forgotten, when addressing the other ones. Therefore, following Buti, Eijffinger and Franco (2003), it seems actually sensible to admit that rethinking the EU Policy Framework to achieve, in some way, a better aggregate fiscal stance would "require a *decisive* leap forwards in the integration of fiscal policy" that is highly unlikely to take place in a Community where the necessities of National Sovereignty have recently, and dramatically, turn up.

4 Reforming the SGP: Literature suggestions

4.1 Introduction

Following the analysis on the Pact's main *pathologies* carried out in last chapter, it seems now sensible to provide an overview and then an assessment of the main *cures* that academics, politicians and opinion-makers have recently proposed.

Moreover, given that some kind of cure to the Pact's problems has to be found, the aim of the chapter is to appraise whether such cure has to be implemented with a "radical reform" approach, as almost all the proposals examined below would suggest, or has to be realized within the current set of Rules.

The approach that will be adopted in the entire chapter is double-edged: first of all, recall of each proposal's rationale is quickly provided, in the light of the findings from last chapter; secondly, and most importantly, a test on each reform scheme, by a cost-benefits criterion involving both economic and political-institutional judgements, is presented, with the purpose of the analysis being to appraise whether a solution carrying *pareto-improvements* may eventually be found or not.

The reform proposals assessed are the following ones: (i) the introduction of the so-called *Golden Rule* of Public Finance – with regards, in particular, to some of its key variants[51]; (ii) the group of proposals centred on the institutional reforms (Wyplosz, 2002; Hallet, 2003; Brunetta and Tria, 2003; Ascari, 2003); (iii) the idea to tackle the aggregate Fiscal Stance, by either a *Permanent Balance Rule* (Buiter and Grafe, 2002) or a market allocation of Deficit Permits (Casella, 2001); (iiii) the proposal of focusing more on Debt

[51] In order of presentation: (i) the *Net Investment Golden Rule,* (ii) the *Gross Investment* one, (iii) the German form, (iiii) the *Cyclically-adjusted* one and (v) the *European Golden Rule.*

Sustainability (Pisani-Ferry, 2002; Calmfors and Corsetti, 2003); and (v) the introduction of a *Good Quality Finance Rule* (Padoan, Rodrigues, 2004).

4.2 The "Golden Rule" of Public Finance

Within the Rules of the Pact, the 3% upper ceiling is applied to a measure of the Budget Deficit including, with no kind of distinction, both *current* and *capital* expenditures. Consequently, this means that, in a *close to balance or in surplus* scenario, all the investment projects will have to be financed by current revenues.

As it has been shown in last chapter, this principle appears rather weak from a theoretical perspective, as it actually implies that the *raison d' etre* of Public Investment funding – spreading the burden of capital projects over the different generations of taxpayers benefiting from them – would have to be set aside in favour of the current expenditures' *pay-as-you-go* approach.

To a certain extent, this situation would be similar to the one in which a company finances its investments matching all the project's cost to only one year's Budget. Consequently, given that by definition an investment is likely to show returns only in the medium-long run, the bankrupt of the firm will rapidly turn up.

Moreover, considering that the timing of *public* investments is likely to show even longer lags before making the project pay off, the scale of the problem definitely widens, carrying huge, negative effects. As a matter of fact, in these circumstances, no Government would be eager to promote capital expenditure, as this would imply re-directing *current* revenues from the coverage of *current* expenditures to that of at present unproductive projects, with, ultimately, the "political death" of the Government itself.

Therefore, as Brunetta and Tria (2003) argue, financing public projects with debt issue should have to be considered physiological – in contrast with the case of current expenditures, that would of course perversely imply putting on *next* generations the burden of financing the consumption of the *current* ones.

In addition, considering the findings from last chapter on the analysis of Balassone and Franco (2000), which are able to explain, first on a theoretical and then on an empirical basis, that a set of perverse incentives has been significantly reducing capital expenditure over time and *de facto* weakening the European infrastructures' framework, the necessity of allowing debt issue to fund investment projects clearly turns up. Summing up, a theoretical rationale – as well as empirical analyses – for some kind of Rule basing capital expenditure's funding on debt issue has been easily found and, therefore, calls for a thorough assessment of the proposals in this field.

4.2.1 Different forms of "Golden Rules"

In such framework, the adoption of a Golden Rule, which would in some way exclude investment spending from the computation of the fiscal parameters relevant to the Deficit calculation, has been recently suggested and heavily debated.
Indeed, the introduction of such rule in the European context may be implemented in five main ways[52], considering either theoretical proposals or solutions already adopted in some countries: (i) the *net investment* rule (Modigliani *et al.*, (1998); Blanchard and Giavazzi, (2004)); (ii) the *gross investment* one; (iii) the "German form"; (iiii) the *cyclically-adjusted* Golden Rule (the UK model); and (v) a proposed "European" Golden Rule (Salvemini, (2003)).

(i) The *net investment* Golden Rule

Straightforwardly, this kind of proposal suggests that the computation of the annual Deficit value should not take into account the *net* Investment Level.
Indeed, before introducing the formulae for this kind of rule, one should consider the two basic conditions below, the bulk of EMU's arithmetic on Deficits. In these expressions, D_t is the General Government Deficit in each year *t*, D_s is its *structural* value, Y_t is the annual GDP and, finally, (0.00, 0.01) is the "safety zone" to ensure the goal of the *close to balance or in surplus* objective[53]:

$$1. \quad D_t / Y_t \leq 0.03$$

52 The approach followed here is based on Balassone and Franco (2000), Brunetta and Tria (2003) and Salvemini (2003).
53 The interpretation of European Commission (2002) setting a target for the deficit of around half percentage point is followed here. See also Giudice and Montanino (2003) for further details on the issue.

$$2. \quad D_s / Y_t \in (0.00, 0.01)$$

At this point, considering the proposal of the *net* Golden Rule, the two conditions above should be changed, taking account of the differential value of, respectively, *gross investment* (I) and *depreciation* (A). Consequently, they become:

$$1. \quad \{[D_t - (I - A)] / Y_t\} \leq 0.03$$

$$2. \quad \{[D_s - (I - A)] / Y_t\} = 0.01$$

Consequently, these conditions imply either an increase in the Deficit *upper ceiling* or a relaxation of the medium-term budgetary objective, depending on each country's level of *net* investment. As a matter of fact, one could re-write them in this way:

$$1. \quad (D_t / Y_t) \leq 0.03 + [(I - A) / Y_t]$$

$$2. \quad (D_s / Y_t) = 0.01 + [(I - A) / Y_t]$$

Thus, the result would be that this kind of Rule would loosen up both targets by the value of *net* investments to GDP, $[(I - A) / Y_t]$, implying therefore an increase in the structural deficit, which, in turn, carries some conceivable negative consequences both in the Debt's trend and in field of Automatic Stabilisation.

At this point, a remark seems appropriate: given that referring to net investment is perhaps the most appealing theoretical version of the Golden Rule, as it has the merit of making the deficit level conditional upon the level of that *part* of expenditures that can actually increase a country's productive potential (HM Treasury, 1998), some evaluation problems are likely to emerge. First of all, depreciation would have to be evaluated *case-by-case*, with the consequence being a strong surge in both operational difficulties and administrative costs, and, secondly, the essence itself of the calculations would be affected by a sort of inconsistency, as public infrastructures actually accomplish several functions and their value may not always be conducted to a market one. Furthermore, as one could easily imagine, a *free rider* tendency towards classifying as much current expenditures as possible into capital ones is likely to turn up, creating serious problems in the complex field of surveillance[54].

(ii) The *gross investment* Golden Rule

Considering the set of problems above, the utilisation of *gross* rather than *net* investments would imply, on one hand, avoiding those difficulties but, on the other one, either leaving the theoretically plain logic of the *net* golden rule or widening the already existent relaxation of the parameters above; actually, the two conditions become:

1. $(D_t / Y_t) \leq 0.03 + (I / Y_t)$
2. $(D_s / Y_t) = 0.01 + (I / Y_t)$

As Balassone and Franco (2000) suggest, in this case the resulting structural deficit would become *inconsistent* with the objective of a sound fiscal stance in EMU. As a matter of fact, both low debt values and high, sustained growth rates[55] would be required to cope with such increase in the structural deficit; indeed, this condition is actually unfeasible, considering first of all Member states with high debts (Italy, for instance) and, secondly, the nowadays' context of weak growth prospects all over Europe.

(iii) The German form

[54] For example, distinguishing between capital expenditure and maintenance costs would become in most cases difficult, if not impossible.

[55] For example, they analyse the case of Spain and UK and they estimate that structural deficit values varying from 1.9% and 4.6% are likely to turn up, considering fluctuation margins of, respectively, 3% and 2%. In addition, the Italian case would be even more worrying, given the huge amount of debt: even with a nominal growth rate of 4.5% and a structural deficit of 3% would imply a Debt ratio unable to decrease under the 100% limit within 2010. We refer back to the two authors' work, *"The SGP and The Golden Rule"*, in Brunila A. et al., *"The Stability and Growth Pact – The architecture of Fiscal Policy in EMU"*, Palgrave ed., page 386.

As Article 115 of the German Constitution says, the *maximum threshold* of annual nominal deficit is represented by the *gross investments* scheduled for the year, as a proportion to GDP. Therefore, the two conditions now become:

$$1. \qquad (D_t / Y_t) \leq (I / Y_t)$$

$$2. \qquad (D_s / Y_t) = 0.01$$

Moreover, this kind of rule would imply changing the annual nominal deficit upper limit from 3% of GDP to (I / Y_t), together with keeping on relying on the mid-term *close to balance or in surplus* objective. Indeed, as Balassone and Franco underline, considering that the 1980-1997 data on the ratio of *gross investment* to GDP show a European average value slightly below 3%, this solution would not imply a significant change from the current framework and would not have any relevant impact on the long-term target of balanced budgets.

(iiii) The *cyclically-adjusted* form

In this model, indeed, the maximum threshold of the *structural* deficit is set at the *average* level of *net* investments over the cycle, with the annual nominal constraint on the deficit left unaltered. Therefore, the two conditions, in this case, are the following ones:

$$1. \qquad (D_t / Y_t) \leq 0.03$$

$$2. \qquad (D_s / Y_t) = [(I - A) / Y_t]_a$$

At this point, two types of problems are likely to come up: first of all, estimating the average level of net investments over the cycle may get difficult, either for the above mentioned difficulties when dealing with depreciation, or for the determination of the reference period upon which the average calculation should be based; secondly, and intuitively, the surveillance process is likely to reach the highest degree of difficulty among all the four models of the Rule. Dealing with each country's computations would actually become very difficult, given that the discretionary component in handling and assessing such data would be very high, if not dominant.

In addition, regarding the medium-term budgetary objective, the value consistent with this form of the Golden Rule would actually be linked to the level of *net* investments, thus on one hand differentiating that objective on a *country-by-country* basis[56] and, on the other one, even if a value close to the Pact's "safety margin" would eventually be targeted[57], linking the structural deficit with the level of net investments and consequently providing strong incentives towards the above mentioned *free rider* behaviours.

(v) The *European* Golden Rule

Following, on one hand, the long list of the difficulties when proposing a Golden Rule on a national basis and, on the other, the observation of the US Federal Budget, which may be allowed to be in deficit, in contrast with the single States balanced ones, Salvemini (2003) argues that the design of a Golden Rule at a European level should be carefully considered. As the author says, it seems rational to admit that in an integrated area such as the European Union a *central* rather than *peripheral* approach in the field of public investments, especially those carrying a trans-european shape or significant externalities among different Member States, should be adopted. Indeed, given that the EU budget is essentially tiny[58] and bound, by statute, to a balanced position, no room would be at the moment[59] disposable to implement such proposal. Therefore, what the author suggests

---

56 A further risk could be, of course, that of a harmful fragmentation of the single national targets, implying also that of the EU rules' one.

57 According to Brunetta and Tria (2003), given that data on the historical net expenditures in Europe are in general very fragmented and in many cases totally absent, such value is currently estimated for Germany as 0. Therefore, using this specific data as a benchmark, one could argue that in many cases the safety margin would be met. Again, however, some differences among European partners make the analysis more difficult: for example, Ireland showed *gross* investments well above 5% of GDP during last decade (Gali and Perotti, 2003), implying, in any case, a stronger amount of *net* annual investments, whatever the calculations to get them.

58 See Note number 32 at page 42.

59 A dismal witness to such condition may be the letter recently sent by six member states to the European Commission to ask for a *reduction* of the maximum threshold to the EU budget from 1.27% to 1% of GDP; this event appears as a symbol itself of a *backward approach* in some communitarian subjects.

would be to introduce, in addition to the current – and chronically undersized – funding resources, the possibility of issuing debt on a European basis[60]. For instance, a maximum reference threshold could be 1% of GDP (~ 90 billions of Euro), able to allow infrastructure and, more generally, development interventions throughout Europe being financed. This, in turn, could imply two virtuous consequences: first of all, it would be a stimulus to activate partnerships with the single Member States – and therefore contributing, without any reform to the SGP, to change the composition of expenditures towards the desired shape; secondly, it would provide an incentive to support private operations in the form of PPPs.

Therefore, and in conclusion, switching the outlook from a *nation-by-nation* to a EU wide one would be, to a certain extent, able to overcome all the difficulties of the previous four models of Golden Rule and to provide a step further either towards an *aggregate* increase in Public Investments or towards a Federal Budget able to promote – rather than discourage, as it seems in its nowadays' shape – an effective European Integration.

4.2.2 Results and Criticisms

Following the debate above, the final considerations are conducted with a three-step approach: initially, an assessment of the four more "classical" versions of the Rule is provided, to find out whether a *first best* solution may be found, then the paragraph proceeds through an insight into the Salvemini (2003) proposal, and, eventually, a *last word* on the whole issue is presented.

Step 1: The "classical" models of Golden Rule

---

[60] Furthermore, the author proposes also what she calls a "second-best strategy", following the line of thought of the proposal above but relying on different *tactical* measures: as a matter of fact, a deficit in addition to the structural one could be permitted to each State, in the measure of the amount of investment expenditure *passing via* the EU budget (but *de facto* financed by national resources). This would actually mean implementing an *indirect* Golden Rule: indeed, it would signify leaving the EU budget in balance and allowing deficit carrying at a national basis. Therefore one could note: (i) the same strategy, (ii) a different method and (iii) indeed, a more complicated and less transparent framework.

First of all, before expressing any kind of opinion on the reform proposal *per se*, it seems consistent with the analysis above to explain which rule, among the four proposed, would possibly best fit the EU nowadays' necessities. Following many authors, it seems that only the *net* investment Golden Rule – either in the Modigliani *et al.* form or in the UK alternative – would be appropriate, as it is the only one which appears: (i) theoretically justifiable, given that it is only the *net* addition to public capital that should be financed *via* debt issue (Buti, Eijffinger and Franco, 2003; HM Treasury, 1998); (ii) consistent with an appropriate Fiscal Stance and with the debt reduction objective (Balassone and Franco, 2000); (iii) in the case of the UK form, the least harmful regarding short-term incentives in the field of deficit increasing, given that the annual threshold remains untouched and therefore it is not likely to imply *immediate* incentives, but rather some medium-term ones[61].

Second, given the opinion expressed at point one above, some arguments against the *overall* theoretical logic of the Golden Rule are discussed below in four *sub*-points.
A primary, heavy criticism is linked to the presumed virtuosity of the expenditure in capital assets rather than current expenses: undeniably, it seems arbitrary to consider, say, investing in a school building *more productive* than in the teachers' wages. Indeed, as also Brunetta and Tria (2003) underline, such kind of "dual budget" may actually, and absurdly, distort the expenditure in intangible assets[62], which are likely to be reduced, undermining the long-run positive effects they can actually show on economic growth (Buti, Eijffinger and Franco, 2003; Sapir, 2003).
A second, essential argument against the adoption of such Rule is the already mentioned incentive to classify *current* expenditure as *capital* spending, which is likely to add further vicious implications in the composition, size and "quality" of Public Budgets. Moreover, and clearly, this *free rider* approach is likely to put significant obstacles both

---

[61] The idea is that only a *mid-run* increase in Public Investment would pay-off, given that the structural deficit threshold depends on the *average* level of investments over the cycle and not immediately on the current one. Therefore, the short-term upper ceiling would remain as binding and 'psychologically tough' as it is currently.

[62] Indeed, the two authors underline that a well-designed Rule could take account of such incentive and could cope with it in some way; on the contrary, it seems that, in the light of the considerations that

in the deficit and debt reduction and in the surveillance mechanism itself: as Giudice and Montanino (2003) argue, it seems difficult to demonstrate that the Golden Rule might be "inter-temporarily *pareto-superior* to the Pact's current shape, considering the serious consequences on the trends of Public Accounts" that relaxing the deficit targets would imply.

Furthermore, following Buiter and Grafe (2003), another crucial weakness of this scheme is that the amount of borrowing that is permitted is *independent* from the real growth rate of the economy. Indeed, it is clear that, *coeteris paribus*, a higher real growth rate would allow more borrowing without adversely affecting debt sustainability and, on the other hand, higher real growth rate would call for a higher rate of investment simply to sustain the capital-output ratio; thus, a rule showing no direct or indirect link with the growth rate of the economy appears, at least theoretically, hardly convincing.

Finally, a last argument against the introduction of the Rule may be introduced: from a general equilibrium perspective, what is actually relevant is the overall capital accumulation, both in private and public capital. Therefore, according to this perspective, as Buti, Eijffinger and Franco (2003) underline, one could for example propose a tax reform that, by lowering the tax burden and its distortions, acting mainly on *private incentives,* eventually leads to higher aggregate investment levels[63]. Indeed, given that of course the scale of some large public investments may not be suitable in a private financing context, a clear scope for the implementation of PPPs appears[64].

Third, vast problems in terms of the surveillance process' procedures are likely to undermine the whole system's efficiency: basically, as commonly agreed estimates of depreciation and of the aggregate public-private investments are not available, a certain procedural disorder would weaken the theoretical rigour of such kind of proposal

---

follow in the paragraph, implementation problems are likely to remain and to affect the whole performance of the Rule.

63 Furthermore, given that of course the possibility of borrowing without strict limits in this field would create a tendency in loosening the policymakers' assessment of the projects' financial and operational effectiveness (Buti, Eijffinger and Franco, 2003), a perverse incentive towards undertaking *underperforming* projects is likely appear; clearly, this efficiency loss will affect the long run general equilibrium of the economy in a negative way.

64 See also in the following chapter the analysis of the *European Initiative for Growth*, the proposal by the European Commission to foster capital projects with a transnational frame.

(Brunetta and Tria, 2003). In addition, also the different "infrastructural stocks" and investment necessities among the European Partners would possibly create divergences able to undermine a rigorous collegial approach to the issue.

Fourth, and finally, designing a Golden Rule in the EU multinational framework would be institutionally and politically difficult. As a matter of fact, the risks of registering discrepancies among the debt 'ceilings', due, in turn, to different levels of national investments, would perhaps be accompanied by "insurmountable mutual suspects of a wicked use of the Rule itself, leaving room for a renewed public spending political cycle and for *beggar-the-neighbour* suspects" (Brunetta and Tria, 2003).
Moreover, it seems that this kind of agreeable criticisms found their roots in the nowadays' fragile European institutional climate, which appears to be in frantic search of *confidence* and *soundness* of the rules, rather than of uncertainty. It seems sensible, therefore, to consider moving towards new rules only if they show those qualities and, straightforwardly, the Golden Rule does not seem to be a wise step in this direction.

Step 2: The 'European' Golden Rule

As also Salvemini herself argues, it seems that a widespread *non-want* to go towards the creation of a Federal Europe is *de facto* affecting any kind of discussion centred on strengthening the role of any *Communitarian* Policy instrument, as the European Budget is – or should be.
Therefore, together with recognising the *first-best* status of such kind of solution, it seems that a sort of political "common sense" should induce separating an optimal choice from a feasible one. Indeed, it seems that the considerations that were made above on the desirability and *pareto-optimality* of the stabilisation function *via* a federal budget may be recalled: again, the institutional and political obstacles in such parallel fields clearly undermines the optimality of the choices and calls for more concrete, even if less appealing, solutions.

Step 3: A "last word" on the issue

Straightforwardly, it seems that adopting a classical version of the Golden Rule would represent a *leap in the dark,* rather than a *pareto-improvement*: as a matter of fact, such proposal would definitely entail both risks and costs that the nowadays' troubled *scenario* does not need any more.

On the other side, the Salvemini proposal – which is undoubtedly appealing and asymptotically close to a first-best solution – lacks of political and procedural feasibility and, therefore, at the current level of European political integration, could not be successfully implemented.

However, and in conclusion, the valuable *raison d' etre* of her analysis should not be forgotten: the idea to act in some way on the EU budget – at least in a context of, say, re-directing the current resources to different targets – to cope with the Public Investments' problem, remains and calls for further analysis.

4.3 Institutional Reforms

It seems fair to consider that, in the European context, the underlying feature of all policies having impacts on the National Public Budget is that it is a single decision maker, the National Government, who is the ultimate responsible for Fiscal Sovereignty. In such decentralised context, however, the SGP has been built as a sort of *coordination contract* among different Governments, who, to a certain extent, allowed tying their hands on the targets' side (i.e. the *close to balance or in surplus* objective) rather than on the tools' one (i.e. the composition of fiscal actions and the "tactical" manoeuvring in the public accounts). Indeed, such kind of *rule-based* coordination has shown some weaknesses and incoherencies over time[65], and, more specifically, it has failed to implement an effective incentive mechanism able to virtuously manage fiscal policies in all the different phases of the economic cycle.

Given this context, some proposals from literature have recently stressed the importance of finding a solution to such "fiscal disorder" on the basis of *institutional reforms*, rather than on rules' revision or redesign. Below, four proposals are examined: first of all Wyplosz (2002) – indeed, the first to suggest something on the issue –, then Hallet (2003), Ascari (2003) and, finally, Brunetta and Tria (2003).

4.3.1 Wyplosz's Proposal

The starting point of the discussion is the consideration – built up mainly on Melitz (2000) and on European Commission (2001) – that during the nineties, in Europe, "the overall stance of fiscal policy has been, at most, weakly counter cyclical". This, in turn, may be explained by the combination of (i) counter cyclical spending and (ii) pro cyclical expenditures and with the conclusive finding (Wyplosz, 2002) that discretionary policy has been *often* pro cyclical.

On the other hand, given this kind of weakness, another problem of a rule-based system of coordination, such as the SGP one, is that the rules "tend to be rigid and artificial" and the limits imposed on deficit and debts appear "arbitrary"; furthermore, if one considers the proposal of a Golden Rule, it seems "based on thin air and falsifiable accounts".

Moreover, if one assumes that there are "inevitable circumstances" where discretionary policies will be needed and could be effective, the problem turns into a different one: to find out a new institutional and political framework able to implement discretionary actions effectively and, perhaps most importantly, *only* when needed – i.e. tackling the pro-cyclical bias of fiscal policy.

In such framework, the author proposes an innovative approach: to build new *institutions*, rather than rules, able to create proper incentives to achieve the objectives of a sound fiscal policy, both in the short and in the long run – i.e. counter cyclical action and debt sustainability. The idea, indeed, comes from a parallelism with monetary policy and its delegation mechanism: actually, given that the aim of fiscal policy is "to credibly combine short term flexibility with long run commitments", monetary policy does face the same concern, of course in a different field. As a matter of fact, its commitment, as well as challenge, is to deliver price stability in the long term, but to help stabilising the output in the short run.

What the author stresses, indeed, is that the crucial change that has recently rehabilitated monetary policy has been the move from rule design to institutional reform, by an extremely specific and goal-oriented delegation mechanism. The idea, first followed by New Zealand, was to delegate to an independent Monetary Policy Committee the clear task to (i) maintain price stability, while (ii) seeing to it that economic conditions are otherwise adequate[66]; moreover, the mechanism has been adopted in many context and, as the ECB's case may prove, it has been usually successful.

But, straightforwardly, how could it be possible to apply such scheme to the complex world of fiscal policy? As a matter of fact – and as also the author suggests – monetary policy is "vastly simpler than its fiscal counterpart", deeply involved in social and redistributive functions, aside from the stabilisation and allocative ones. Moreover, while it is fair to assume that those tasks cannot be easily delegated to a single agent, Wyplosz provides an interesting solution, claiming that fiscal policy fulfils two very different tasks: a first one is centred on redistributive choices – i.e. the size and aims of expenditure items and the tax system structure – while a second one deals with macroeconomic issues – i.e. the overall strategy of counter cyclical action.

According to the author, the second task "does not fundamentally differ from monetary policy and, to a first order of approximation, it could be designed *independently* from the first one", by the delegation to an agent which would be, to a certain extent, the fiscal counterpart of a Central Bank. Therefore, the idea is to create an independent committee that would be allowed, in some way, to implement the macroeconomic aspect of fiscal policy making, in the same way as a Central Bank independently runs its policies following a precise constitutional mandate.

In such context, two aspects appear crucial: first of all, strictly and clearly defining the goals of such mandate (altogether with, of course, ensuring sufficient independency from the national Government) while, secondly, giving an appropriate degree of ability in exercising judgement and in implementing actions.

---

66 An insight on the issue of delegating monetary tasks to independent committees may be found in Blinder et al. (2001).

The analysis of the Wyplosz's proposal for a Fiscal Policy Committee (FPC), embodying those two critical issues, is provided below.

The Wyplosz's idea is centred on the design of an independent Fiscal Policy Committee, on a country-by-country basis, that would be made responsible for setting a *target* for the annual national budget balance. Basically, the operating scheme would be that first the Committee would choose the balance objective and then Government and Parliament would be able to concretely implement interventions on expenditures and revenues necessary to hit the target. The Committee would be based on (i) a small number of qualified people for long, non renewable terms of office and not allowed to seek or receive instructions from Governments or MPs, and (ii) it would be supported by a staff producing economic forecasts, budgetary figures and analysis, to ensure both independence and autonomous judgement.

The FPC would endorse a clear and explicit *long run* mandate, that of debt sustainability[67], while allowing to freely choose deficits and surpluses in the *short run*. However, the power of the committee would be limited to set annual deficit figures (say, % of planned GDP), *ahead* of the Governmental budgetary choices, but it would have the force of law and impose itself on the both the national government and parliament. Of course, the FPC would not have any power or authority regarding the size of the budget, the tax structure and the allocation of public spending; therefore, as it has been emphasised above, the macroeconomic function of Fiscal Policy would be clearly separated from its distributive one, which would remain managed by the traditional political process.

The budget bill would be approved by the Committee before becoming law, and any budget not complying with the FPC balance decision would have to be re-drawn or, following an automatic procedure, brought in line in some way (for example, via a *pro-rata* mechanism on revenues and expenditures). In addition, and finally, in the event of sudden changes in the economic conditions, the FPC would have the power to mandate a change in the budget law.

---

[67] To figure out how to practically express the Debt Sustainability objective, see page 9 of Wyplosz, "Fiscal Policy: Rules or Institutions?", April 2002.

4.3.2 Other Forms of Authorities

Of course, the Committee designed by Wyplosz would not be the only possible one: as for example Ascari (2003) has underlined, different degrees of powers, duties and responsibilities could be set, given that this issue is "definitely the most difficult and delicate problem, as it touches the borders of democratic powers". Consequently, the author suggests three different possibilities to design an authority: a weak version, an intermediate and a strong one.

The *weak* form would follow the Danish experience, relying on an Experts-based Committee who publicly makes judgement on the Government's budget bill and suggests amendments; indeed, the overall effectiveness of the system would rely on the authoritativeness of the Committee and on its ability to influence both public opinion and financial markets.

The *intermediate* version would instead be based on a more formal and strict relationship with the national Government: for example, detailed reports and public "question times", but also, perhaps, some forms of autonomous decision on the planned annual deficit, with only the possibility for Government and Parliament to change them with large, qualified majorities.

Finally, the *strong* form would be similar to the Wyplosz's proposal, with the authority having tough powers regarding deficit targets and/or the variations of some specific tax rates; moreover, Ascari himself comments that this solution "would not be mature for our times", given that it would imply redistributing a big amount of power from Government and Parliament to the Committee and, therefore, it would entail politicians' hostility[68].

However, whatever the choice between the possibilities above, the core idea would be to allow a more flexible management of fiscal affairs, while ensuring long term sustainability of debt and resolving the SGP Rules' current *impasse.*

---

[68] Indeed, as the author says recalling Calmfors, a Swedish economist, "the very reason of the desiderability of this proposal is the politicians' hostility […]. If politicians thought it would not make any difference, they would not be against it; however, they are hostile towards it specifically because the perceive their freedom of action would be limited". And "this is exactly the aim of the proposal".

Two other interesting proposals in this field have recently come up, following a similar logic but on a different basis, from Hallet (2003) and Brunetta and Tria (2003).
Hallet proposes to set up a "Sustainability Council for the Euro Area", following the Wyplosz's idea of substituting *rules* with *living bodies*, but with two different key features: first of all, the authority would be a centralised European institution, rather than a national one, and, second, it would rely on "political pressures generated through public opinion and financial markets". The idea is, therefore, to safeguard the sustainability of Public Finances (while allowing room for short term flexible manoeuvring), but *via* a centrally based board, which would report to the European Parliament and would not have an operative role, such as setting taxes or expenditures, but would rely only on "making the implications of the Governments' intertemporal budget constraint explicit".
Operatively, the Council would be free "to develop an empirical concept of sustainability" and it would not be bound to specific targets – such as, for instance, the inflation target for the ECB – nor specific instruments apart from publicly disclosing its opinions; again, the core message of the proposal is that a *living body*, with its independent and qualified judgement, would be better able to cope with the "sustainability-flexibility trade-off" and would eventually better suit the nowadays' European necessities.
Furthermore, and interestingly, such (i) *inability* to set taxes and expenditures and (ii) freedom of expression and judgement would mean ensuring, on one hand, some sort of indirect democratic legitimacy[69] of the authority and, on the other one, a case-by-case, unbiased approach able to provide both long term discipline and short term flexibility – as the ECB has been recently and successfully doing, in the monetary context.

Finally, Brunetta and Tria (2003) suggest proposing – following, indeed, an innovative outlook – each country's Central Bank, or one of its branches, as the independent fiscal authority. This solution, indeed, would have the advantage of "favouring the coordination between monetary and fiscal policies", even if of course in the European

---

69 See the conclusions' subparagraph (3.3.3) below for an insight into the democratic accountability of this kind of authority.

Union national Central Banks follow the ECB's addresses, rather than directly acting in monetary policy. However, such hypothesis would be interesting, as "the national Central Banks would acquire the direct control of an instrument aimed at copying with asymmetric shocks, while following the ECB's monetary policy strategies for tackling the symmetric ones" and, to a certain extent, they would borrow (and then benefit from) credibility from the ECB itself. Regarding its powers, the two authors propose that it would be possibly allowed to operate on (i) some types of transfers' expenditures or (ii) on a tax rates, either direct or indirect, with a precise range of setting from a central value (i.e. plus/minus *x %*); the aim being to give the Committee some concrete means of policy action, while not touching the Government and Parliament's ability to freely define the social and distributive framework of their annual budgets.

Again, therefore, although presented in different forms and with different powers, the core idea remains to set up an independent authority able to manage the *macroeconomic* aspect of fiscal policy, following the Central Banks' model and, therefore, an objective of either higher independency and credibility in managing fiscal manouvres.

4.3.3 Critical issues

"There is no reason why FPCs should be less successful than MPCs (…). Competent and dedicated policymakers are better able than quantitative ceilings to exercise good judgement and deliver an adequate mix of restraint and flexibility". This statement by Wyplosz may be considered as the key point, as well as conclusion, of his analysis, but one could also regard it as the core issue of all the different proposals in this field. Indeed, given this belief, Wyplosz himself analyses what from a *theoretical* and *institutional* perspective could be considered as the main weak point of the proposal: democratic accountability. As a matter of fact, the author explains that the entire scheme could be seen as a "technocratic encroachment on a fundamental aspect of democracy", given that Fiscal Policy is at the very heart of political decision-making process; however, he proposes three main counter-opinions to defend his point of view.

A first, primary point is that budget deficits actually have "limited intra-temporal reallocation effects", as they mostly redistribute income *across* generations, rather than *among* them. Indeed, it is only the size and structure of the budget – and, consequently, also the taxation structure, which actually determines public revenues and wealth redistributions among people – that does matter, and thus there are no reasons to accuse the Committee setting a deficit target as a democratic overrun.

A second consideration is linked to the actual possibility of separating the macroeconomic aspect of fiscal policy from its allocative and distributive features, *via* a well-designed, circumscribed delegation mechanism that would eliminate interferences in a field where democratic accountability is a key feature. The idea is that if taking the deficit and debt out of the standard democratic process is decided when it is "fully justified", via a bounded mandate, following the monetary framework's model, no perverse effects will arise.

A third, final argument is Parliamentary Oversight: actually, the FPC would be accountable to a national *elected* body, and it would be controlled either *ex-ante* or *ex-post*, by regular testimonies and reports on the Committee's policy decisions and by making the authority responsible for its record.

Undoubtedly, these kinds of considerations may appear convincing, making what is of course an intellectually appealing proposal more feasible and, perhaps, less hostile from an institutional point of view. Furthermore, considering the proposals by Ascari (2003), Hallet (2003) and, to a certain extent, Brunetta and Tria (2003), one could also argue that some smoother solutions could be found, following the Wyplosz' model *raison d' etre* while entailing less institutional, political and procedural difficulties: for example, the idea by Ascari to build a Committee in the "intermediate version" or the Hallet's "Sustainability Council" without direct powers on taxes and expenditures, could imply less radical consequences, while achieving some key goals.

However, and in conclusion, even if theoretically interesting, the entire spirit of such proposals, either in the Wyplosz originary form or on its variants, has to be criticised, in our opinion, for three essential reasons:

- <u>Feasibility</u>: indeed, it would be very difficult – if not impossible – to separate the different functions of Fiscal Policy, as, even if such tasks do differ, no mechanism to *practically* and *successfully* split them may be found. And the main reason is that Fiscal Policy lies at the heart of the political decision making process and that, actually, each decision on the budget's size and composition is likely to have macroeconomic impacts, and *vice versa*[70]. Curiously, also Hallet, who is actually in favour of a rather *weak* form of Authority, underlines that the Committee "could hardly make a judgement on the sustainability of a country's Public Finances without forming an own view of the size and structure of its public sector" and the likely contrasts of visions could "easily lead to disagreements", due to the democratic gap between different institutions and on a question of accountability.

In addition, following Buti, Eijiffinger and Franco (2003), it seems fair to recognise a very factual, but indeed important, implementation problem: as a matter of fact, given the reasons – or wrongs – of politics, "it would be hard to conceive that a minister of finance would delegate part of fiscal policy to an independent agency", and, therefore, one could easily foresee an *impasse* scenario, with officials trying to separate powers that now are tightly in the hands of strong policymakers, as finance ministries are.

- <u>"Sticks and Carrots"</u>: straightforwardly, even assuming that the feasibility problems above could be overcome, who will be able to guarantee that the independent authorities would be actually able to set effective incentives for governments to behave virtuously? This point is far from being clear or predictable, if one considers the events of year 2003: as a matter of fact, a strong and independent[71] board such as the European Commission was not able to successfully discipline Governments, also taking into account the *ex ante* menace of the EDP, which only *ex-post* has proved ineffective. Consequently, it seems quite arbitrary to believe that a young, newly appointed Committee would be able to discipline Governments more successfully than the Commission[72]. In addition,

[70] Here the stress is on the *political* and *institutional* consequences of these links and their impacts, given that one may possibly embrace Wyplosz's belief that deficits have *limited* redistributive effects: indeed, rather than the *size*, what does matter is the *inner meaning* of such effects, which is likely to undermine the possibility of concretely and successfully separating the two functions of Fiscal Policy.

[71] It seems fair to recognise the high degree of independency of this board, even if its members of course cannot be considered *completely* free from political and national matters.

[72] Furthermore, except from the Hallet's proposal – which, indeed, may be blamed for being too utopistic, given nowadays' Europe – all others entail a significant weakness: in fact, they may imply a further step

principal-agent problems are likely to turn up between the authority and finance ministers, if one thinks about the incentives towards "bad aims" (i.e. time inconsistency) and "bad tools" (i.e. creative accounting and off-balance operations[73]), which are very likely to arise. Therefore, while admitting that of course a certain degree of credibility and authority could be gained by a well-designed proposal, it seems difficult to imagine Governments taking responsibly account of the suggestions by a body which lies "in the middle of nowhere", both from a democratic and procedural point of view. In conclusion, a new framework characterised by both less credibility and less enforceability is eventually likely to be created.

- A final comment: an opinion by Casella (2001) – which was actually expressed[74] even *before* the proposals examined in this paragraph were presented but that *ex post* may either directly address the Hallet's proposal or, more interestingly, the entire logic of the *Wyploszean* reform schemes – seems exemplary and self-explaining: "In a world where a benevolent and perfectly informed central planner existed, a centralised solution would be possible. All decisions would be deferred to the centre: in the same way as countries have relinquished their monetary policy, they would also lend their fiscal powers to a European-wide body. At least in the short run, neither the institutions, nor the political will are in place to make such scenario feasible or in fact desirable".

4.4 "A Permanent Balance Rule" *versus* "Tradable Deficit Permits"

back in the field of Communitarian achievements, given that a nation-by-nation design of the authorities would imply fragmentation and dispersion of statutorily considered European matters.

[73] Not surprisingly, the considerations made in chapter two about these kinds of misbehaviours may be fitting this scenario: actually, as long as we have a principal-agent situation, *moral hazards* are likely to turn up and, whether not menaced by strong and credible sanctions, they can be hardly eliminated.

[74] Alessandra Casella, *Tradable Deficit Permits,* in Brunila A. et al., *"The SGP – The architecture of Fiscal Policy in EMU"*, Palgrave, page 396. Indeed, the author herself says her contribution in that book refers to a *previous* and longer study (Casella, 1999). For a detailed analysis of Casella's proposal, see the paragraphs below.

"The performance of all countries need not be the same,
nor need the performance of each country at different times"

Alessandra Casella[75]

This paragraph follows the aim of presenting two reform proposals that, far from being similar, are actually designed following a related logic: that of considering a European-wide outlook, when dealing with the SGP reform proposals, carefully taking into account the significant differences in the countries' Public Finances structures. As a matter of fact, literature suggests that in a Monetary Union, such as the European one, it is the *aggregate* Fiscal Stance that is relevant for an adequate policy mix. Indeed, the *one-size-fits-all* framework of the SGP has recently proved unable to fit the different situations at a national level, and therefore, some kind of intervention in this field seems, appropriate, at least following an *ex ante* outlook.

Regarding the proposals, a first one to be considered is from Buiter and Grafe (2002), focused on the so-called "Permanent Balance Rule", which should be able to ensure sustainability and fiscal prudence while taking into account country differences; a second – and indeed very peculiar one – comes, instead, from Casella (2001), who bases its plan on the implementation of a system of "tradable budget deficit permits", following the example of the currently operating US transferable pollution permits.

The analysis below provides an assessment of each single proposal and, eventually, expresses a joint conclusion on the topic.

4.4.1 The "Permanent Balance Rule"

The idea by Buiter and Grafe (2002) is, basically, to propose a medium term target that rigorously ensures long term sustainability[76], while taking into account country specificities. More specifically, they propose a *tax rule* that ensures the Government's solvency and has other attractive features, from the perspective of cyclical stabilisation and the minimisation of the "excess burden" of distortionary taxation. Moreover, the

---

[75] From Casella, *Tradable Deficit Permits,* in Brunila et al., *"The SGP – The Architecture of Fiscal Policy in EMU"*, Palgrave, page 398.

[76] It is important, indeed, to underline that one peculiar feature of this proposal – which will be further explained in the paragraph - is that sustainability is pursued *via* linking a *budget* target to a *debt* one.

entire logic of the proposal founds its roots on the wide literature on *tax smoothing* – following, among others, Barro (1979), Deaton (1981) and Lucas and Stokey (1983)) – and relies on a strong form, which, straightforwardly, requires that "the inflation-and-real-growth-adjusted *permanent* governmental budget is in balance or in surplus". This long and unfriendly expression has, actually, a rather simple meaning, which is explained in the box below, referring back to Buiter and Grafe (2002) for further details on the arithmetic.

Box. 3 The *Permanent Balance Rule*

The rule can be easily expressed in this way: the share of government taxes in GDP, τ_0, has to be kept constant at a value, τ_0^p, no less than the sum of the *permanent* public spending share in GDP, g^p [77], plus the long-run growth-adjusted interest cost of the public debt, $(r^p - n^p)b$, minus the *permanent* government capital income, $\theta^p k^p$. That is:

$$\tau_0 = \tau_0^p \geq g^p + (r^p - n^p)b - \theta^p k^p$$

(continues)

[77] More specifically, the permanent public spending, g^p itself is the sum of (i) the permanent government transfer share; (ii) the permanent public consumption share; and (iii) the permanent public investment share.

Where:

Permanent refers to that constant value – in a *perpetuity* – of whatever item or variable whose present discounted value is the same as the present discounted value of the actual (or anticipated) future sequence of the items themselves

$(r^p$ - $n^p)$ is defined as the *permanent* (or *long-run*) real interest rate minus the *permanent* real growth rate. It is that constant value of the excess of the real interest rate over the real growth rate that generates *the same* value for this real perpetuity as is generated using the actual (or anticipated) future values of $r-n$.

θ^{p} is the *permanent* gross financial rate of return on the general government capital stock.

k^p is the *permanent* ratio of the public sector capital stock to GDP.

This tax smoothing rule means, therefore, that the *inflation-and-real-growth-adjusted permanent government budget* is in balance or in surplus. Moreover, it is called the Permanent Balance Rule, because of its analogies with the so-called "permanent income hypothesis of household consumption". Actually, a household's permanent income is that constant (or *permanent*) level of consumption that has the same present discounted value as the actual (anticipated) future endowment stream plus initial financial wealth. If a household consumes its permanent income, that consumption level is (*ex-ante*) the *highest* constant sustainable level of consumption over its lifetime.

Thus, the Permanent Balance Rule for the share of taxes in GDP is defined as that constant value of the share of taxes in GDP whose *present discounted value* (over an infinite future time horizon) equals the outstanding stock of public debt *plus* the present discounted value of actual government spending *minus* government capital income, all taken as shares of GDP. Moreover, and in conclusion, the theoretically interesting feature of this rule is that, if the tax structure does respect it, the long-run (or steady-state) government debt-GDP ratio is *constant* ex-ante, meaning that, by definition, the Debt Burden of each country is sustainable. Consequently, three main goals seem to be achieved: (i) that of prudently ensuring long term sustainability[78], (ii) that of allowing some room for short term, anti-cyclical adjustments – which are, to a certain extent, absorbed by the long run horizon over which the rule is based, and (iii) that of allowing an effective and rigorous *country-by-country* approach, able to cope with the different needs of each European country.

Furthermore, considering the context of the upcoming European Union Enlargement, such kind of rule could be a good basis to allow the "catching up" of the accession countries, which show not only different realities, from the current EU average, in the structure of Public Finances, but also in their expected future inflation rates, growth potential and public sector capital. Basically, the idea is – following also Buti, Eijffinger and Franco (2003) – is that as, in general, catching up countries are characterised by higher potential growth and higher inflation, they could afford having higher deficits without endangering the long term sustainability of Public Finances. In conclusion, the Permanent Balance Rule would allow, at least from a theoretical perspective, a sound mechanism able to get overall stability, long term sustainability and country-specificity.

4.4.2 Problems of the Rule

As also the authors themselves admit, one main weak point of the proposal is that the rule requires *the estimate* of the *permanent value* of tax and spending, thereby requiring to take into account future social and political preferences and make assumptions on future growth rates. Definitely, such requirements would complicate, and then undermine, the effectiveness of the overall fiscal framework's working; indeed, it seems fair to agree

[78] Using Buiter and Grafe's own words: "if the tax rule in holds with equality, the (*ex-ante*) constant share of taxes in GDP is the smallest constant share of taxes in GDP *that would satisfy the government's intertemporal budget constraint or solvency constraint*".

with Buti, Eijffinger and Franco (2003), when they say that the rule "would be likely to violate the simplicity and enforceability criteria [*of an ideal fiscal rule*]". Thus, one may foresee a scaring scenario of bureaucratic and political *impasse*, with officials, economists and policymakers fighting each other on data and forecasts: the result being either more disorder or less transparency.

In addition, also one of the most appealing features of the rule – the good fit with the accession countries' necessities – may *ex post* prove weak, as even if, in general, nominal GDP growth should be higher in catching up economies, it is also likely to be highly variable. Actually, this implies a potential conflict between discipline and stabilisation (Buti, Eijffinger and Franco, 2003), as when a country with high deficit is hit by a shock, the working of automatic stabilisers may lead to very high deficits, with the concrete risk of (i) transforming a cyclically-driven deficit into a dangerous way of "spiralling debt and interest payments" and of (ii) "drying up capital inflows", given the limited creditworthiness of those countries. Therefore, the consequences of such variability could be very destabilising, proving that – together with an indeed interesting *country-by-country* approach – the Permanent Balance Rule could entail a large number of risk and dangers.

4.4.3 The 'Tradable Deficit Permits'

Intuitively, another way of pursuing a differentiation between the countries' dissimilar needs could be to set a deficit (and/or debt) target for the Euro area as a whole and then, in some way, *to share* it between the European partners. Following this outlook, Casella (2001) has proposed a solution, based on the experience of US environmental markets, which relies upon a *market mechanism*[79], to allocate and then to trade permits for deficit

---

[79] For completeness, one should note that, in theory, also a *political-bureaucratic* allocation mechanism could be considered; as a matter of fact, a coordination mechanism allowing cross-country compensation of deficit/surplus positions could be implemented by (i) aggregating national programmes into a "Euro area stability programme", (ii) assigning "national contributions" so that individual member states would be permitted to overshoot the Pact's 3% threshold as long as there were other countries with deficits below that value. The idea, proposed by the then French Finance Minister Dominique Strauss-Khan at the informal EcoFin Council in Dresden, in April 1999, profoundly lacks of feasibility as first of all rules should be renegotiated (in a foreseeable frightening context of political struggle to gain "as much as possible", from a national point of view) and, secondly – and most importantly – they would be substituted by a loose framework in which *free riders* would have many resources and ways to do their

creation. Basically, the idea would be to combine the *overall* objective of fiscal discipline with sufficient flexibility for *individual* countries, by an efficient allocation mechanism, which would ensure a solution to the sustainability-flexibility *dilemma*. Moreover, the underlying logic would be a combination of the belief that markets are unable to discipline Governments and that, on the other hand, they are able to play an important role in the allocation of resources.

The starting point of her analysis – indeed agreeable, as well as in line with this work second chapter's perspective – is that the nowadays' structure of the SGP, imposing the same deficit criterion to each EU country, leave no room for country-specific cyclical phases. In addition, another important and critical element is that "there is no reward for virtue", in the sense that a sound "fiscal behaviour" in good times is not rewarded.
Given these considerations, a solution to such problems could be found by borrowing the logic and operational mechanism from the US Pollution Permits: a system of tradable deficit permits that sets a *total limit* to fiscal deficits and uses the market to allocate them across the different countries at minimum cost. Indeed, the idea ingeniously follows the results from environmental economics literature, which underlines that the *command-and-control* approach (i.e. the quantitative limits on pollution) reveals itself, *ex post*, a failure, given (i) the *free rider* behaviours of economic agents, (ii) the weakness of the *ex ante* punishment menaces and (iii) the impossibility of an *ex post* thorough and strong control. Correctly, Casella explains that the SGP's fiscal framework would not significantly differ from the environmental one and, therefore, sets the case for implementing that system – which has actually proved successful, in the USA, in reducing average pollution levels and in not leading towards pollution "hot spots" or concentrations (Ellerman et al., 1997) – in the European context. To put it with her own words: "the scheme currently envisioned by the SGP consists of uniform quantitative constraints on each country's deficit, and the observance of this limit is likely to be associated with *very different costs*, depending on the country's structure, debt overhang and cyclical phase […]". "A system of tradable deficit permits would allocate deficit

best. In conclusion, therefore, no further analysis on the issue will be provided, and, instead, focus will be put on the *market allocation* mechanism by Casella.

where their value is higher[80], making it possible to implement the desired fiscal discipline much more efficiently".

More specifically, the scheme would work in this way[81]: each year, every country is allocated a number of deficit permits, equivalent in some way to the 3% of GDP, given that those permits could in practice be "special accounts" maintained by each country at the ECB, or at the European Commission, and would be denominated in Euros and freely tradable. At the time when annual fiscal statistics are made public, each country *must have* in its account a sufficient number of permits to cover the year's deficit, and such permits are withdrawn from the system[82]. In case a country is found not in compliance, it faces a steep fee for each of the missing permits and must relinquish a corresponding number of permits from the following year's allocations.

However, each country could also *buy* (or *sell*) the permits: if, say, a country is hit by a negative shock, it can use fiscal policy to counteract it by buying permits from surplus countries, actually allowing deviating from its initial allowances. But – one could ask oneself – at what price? The answer is that the cost of going above the 3% ceiling would be, at any given time, "the *market* valuation of a fiscal expansion at that time, taking into account either the overall ceiling or the option of banking permits for the future"; this would mean that, if the ceiling were chosen correctly, an *efficient* pricing would arise.

Regarding the merits such scheme would entail, one could identify them into two broad categories: first of all, *nation-focused* advantages and then *EU-wide* ones.

Focusing on the first ones, either Casella (2001) or Buti, Eijffinger and Franco (2003) underline that a key goal would be that of ensuring a higher degree of flexibility at a national level, given that of course the performance of all countries need not be the same,

---

80 Here, the analogy with the environmental field is very high if one considers (i) the choice between the *cost of depuration* and the *cost of pollution rights* and (ii) the consequent efficient solution *via* a market mechanism.

81 The mechanism described here is the simplest version that can be found in her proposal. We refer back either to Casella (2001) or to Casella (1999) for further details.

82 In addition, following the experience of the environmental markets, "it seems advisable to let countries' *current* bank permits for future use, while of course not allowing to borrow from *future* allocations". In practice, this would mean that deficits could be offset by permits carrying a date contemporaneous with or preceding the year of the deficit. The logic is, actually, that this rule would leave some room for intertemporal planning and anticipated shocks, while limiting governments' *free riding* temptations.

nor need the performance of each country at different times (Casella, 2001). Furthermore, such flexibility may be seen from a double perspective: as a matter of fact, while allowing room for manoeuvring in bad cyclical conditions, it also provides rewards for countries running surpluses in favourable cyclical conditions, offering what can be fairly considered as a good incentive to behave virtuously in good times. In conclusion, the overall, brilliant result would be that "the increased flexibility works both through imposing the *correct costs* to fiscal expansion and the *correct rewards* for fiscal cuts", meaning that a cure to both the Pact's rigidity and asymmetric nature could be eventually found.

Considering the second group, instead, one could say that two another important goals would be achieved: first, that of minimising the *aggregate* cost of compliance with the Pact's targets, given that, as it has been said above, different countries face different compliance costs; second, such kind of EU-wide flexibility would imply that "a country could intervene *before* experiencing a severe contraction" and not, as it happens in the nowadays' scenario, after having experienced it.

Summing up, this brief assessment has actually found valuable results, of course in a theoretical perspective; indeed, one should note that such plain and direct advantages had not yet found in any of the proposals above and, before analysing the problems, exposed below, it seems fair to admit that such proposal has definitely a certain attractiveness.

4.4.4 Problems of the Mechanism

At this point, three main weak points may be outlined, the first two being suggested by Buti, Eijffinger and Franco (2003) – who are, indeed, almost the only ones having showed some kind of interest in the proposal – and the third one only partially.

First, the good performance of the proposed system would require the assumption that the deficits of various Governments generate the same externality and are therefore *perfect substitutes*. However, obviously "the risk of triggering a financial crisis is not uniform across governments and states" and the only way of coping with this weakness would be that of taking into account the debt level in each country – for example, "making the value of the deficit permits inversely proportional to their stock of debt"; indeed, such change would definitely imply complicating the system and thus creating room for political and bureaucratic misbehaviours.

Second, there is clearly a problem of competition, given that Governments in Europe are not in large number and that, consequently, this could deeply affect the degree of efficiency of the market. Perhaps, the EU enlargement process could in some way alter the scale of the problem; however, no studies on the issue have turned up so far and predictions are of course delicate in this field. In addition, even thinking about a 25 members EU, clearly some economically and demographically important countries would be likely to exert some kind of power in an *imperfect* market.

Third, and perhaps most importantly, although one should admit that such system appears well designed and efficient, at least from a theoretical perspective, considering its automatic working and transparency, it seems that a certain degree of prudence should be kept, when making a judgement on it. Our idea is that, far from the limited values, volumes and interests of the market of the Pollution Rights, such system could prove less effective in a context where politicians and bureaucrats would do everything for profiting on some inevitable, even minimal, imperfections or frictions that every market embodies. More specifically, our idea is that, given that powerful incentives towards gaining as much room as possible for fiscal manoeuvring entail the current EU fiscal framework, every small *piège* of the system would be exploited: for instance, critical moments such as that of a sudden contraction in the permits' supply, in the case of a severe downturn, or, as Buti, Eijffinger and Franco (2003) suggest, that of the *initial* allotment of permits.

4.4.5 A Joint Conclusion

Undeniably, the two proposals above appear as the two theoretically most rigorous that have been examined so far; as a matter of fact, if the Permanent Balance Rule has impressed for its consistency and crystal-clear rationality, the Tradable Deficit Permits system has shown a great appeal, considering its (at least *ex ante*) efficiency and transparency. However, given the specific and technical problems of each proposal – whose biggest ones are, perhaps, respectively, the difficulty of the main variables' estimates and the *imperfect* substitution between deficit rights of the same amount but from different countries – it seems that a common, and indeed crucial, weakness could be found, on a different field: that of the excessive difficulty and intricacy of the mechanisms. As a matter of fact, considering the simplicity – of course aside from the large number of defects – of the current SGP's rules, the two proposals move in the opposite direction, risking loosening the system's effectiveness, from a procedural, bureaucratic, and political point of view.

In addition, as a consequence to such simplicity, one of the key features of the current European rules is that they are very easy to grasp by the public opinion. Definitely, such characteristic has proved valuable over time, creating (or adding, at least) some incentives for Governments to behave properly – or at least less harmfully than they would have done. Therefore, it seems it would be a pity to lose it, given that newspapers speaking about the long term variations of the *permanent tax rate* or of the deficit permits' price are likely to leave public opinion indifferent.

In such context, also the other big merit such proposals were looking for – i.e. the possibility of differencing the countries' targets, given the proved differences among their economic structures, conjunctural situations and long term necessities – appears somehow not really valuable or desirable. Again, actually, it seems that the argument of the "leap in the dark *versus* pareto-improvement", which has turned up very often when assessing the reform proposals, here would advise not implementing them[83], considering their certainly big controversial features. To use a short expression, one may conclude that the two proposals could perhaps be a step forward in some fields, but they would eventually be too complex, too knotty and too risky.

4.5 Focus on Debt Sustainability

"There is a strong case for taking government debt into account when judging whether a member state has an excessive deficit"

Lars Calmfors and Giancarlo Corsetti [84]

---

83 Perhaps, the suggestion from Buti, Eiffinger and Franco (2003) of *testing* the system of tradable deficit permits on a sub-national basis (i.e. by allowing the regions or counties trade the permits among them) could be considered interesting and could be implemented. However, all the doubts expressed on the proposal above remain.

84 The Financial Times, *"A better plan for loosening the Pact",* 26th November 2002.

The starting point of the issue is that, as one could easily find, the SGP does focus on the analysis of deficit's behaviour and trend, but shows less rigour in the debt's one. Consequently, the *different* countries' debt burdens are not properly considered and *criss-cross* examined, thus meaning that differences among the EU national Public Finances are in some way disregarded.

In this context, two recent proposals, one from Pisani-Ferry (2002) and the other from Calmfors and Corsetti (2002), have been made to cope with such double-edged weakness; basically, they are both aimed at pursuing some kind of more *medium term oriented* approach that focuses on the long run sustainability of Public Finances rather than on the short term deficits' dynamics.

4.5.1 The "Debt Sustainability Pact"

The core idea of the Pisani-Ferry's proposal is that the *option* to subscribe a Debt Sustainability Pact would be offered to European member states, with the aim of excluding them – under some precise conditions – from the Excessive Deficit Procedure.

More specifically, the countries participating in this "new Pact" would have to follow the following peculiar dispositions:

(i) They would have to publish "comprehensive Public Finances Accounts according to the improved EU accounting standards, which allow assessing the potential future impact of off-balance sheet liabilities";

(ii) They would have to "keep their Public Debt Ratio, under the Maastricht's definition, *below*, say, *50% of GDP*";

(iii) They would be bound by a "five years target" for the Debt Ratio, that "would serve as a benchmark for assessing their budgetary policy";

Moreover, countries satisfying these three conditions would automatically qualify in what the author calls "the No-Excessive Deficit Procedure", meaning that "they will be exempted from the fines envisaged in the Stability Pact". However, failure to comply with *any* of the three points above "would automatically re-activate the standard

Excessive Deficit procedure" and, if the peculiar conditions should require it, countries would be sanctioned accordingly to the procedure's rules.
In addition, aside from this core idea, another new element would be that of an "Economic Charter for the Eurozone", which would be set up as a sort of Code of Conduct focusing on a common understanding on some key economic policy principles; the suggestion is to strengthen the coordination in the Economic framework, among the EU members, *via* a non-binding but rather *voluntary* further commitment. Indeed, such Code would be an essential reference point, regarding the structure and contents of the Stability Programmes: as a matter of fact, following its principles, they "should spell out how it is intended to alter budgetary policy in response to output and price surprises, as well as in case of revenue shortfall or surpluses […]". Such presumptive responses would "serve as a benchmark against which policy decisions would be assessed by EMU partners and market operators". Furthermore, the author also argues that additional steps forward could be made to reinforce the overall architecture of the system: first, to set up "a reciprocal binding agreement" by Eurozone members to consult their partners and the Commission *before* significant Economic policy decisions are taken and, second, to propose the replacement of the rotating presidency system "by the designation of the Eurogroup president for a fixed period", further aiming[85] at a transformation of that body into "a collective executive board with the ability to make decisions by qualified majority voting".

Summing up, the essential aim of the proposal would be double-edged. First of all, to shift the current Pact's concern on the deficits' behaviours to a more mid term oriented approach focusing on debt sustainability, *via* the *option* for EU members to underwrite a Debt Sustainability Pact. Second, to strengthen the economic coordination process among countries, to ensure that policy decisions on a national basis would (i) be consistent with the principles of the proposed Code of Conduct and (ii) be streamlined and reinforced,

[85] Indeed, Pisani-Ferry himself describes such goal as "controversial", given the political and institutional climate of nowadays' Europe. Furthermore, even if not boldly expressed, a "constructive dialogue between the ECB and the Eurogroup" on the interaction of macroeconomic policies and structural reforms would be desirable, given that, of course, a strong and *one-voiced* Eurogroup is a key prerequiste.

following a strong "centralised perspective"; in addition, significant institutional improvements and achievements are aimed, to further gain more coordination.
In conclusion, it seems that the *optional* nature of the entire proposal arises, meaning that the current Pact's Rules would remain as a sort of "minimal platform", which, in case of need (i.e. non compliance) would become once again binding and could lead to the activation of the sanctions' mechanism.

4.5.2 Calmfors and Corsetti's Way

The two authors, first in 2002 and then, again, in 2003, suggest a reform proposal of the Pact to explicitly *link* the *short term* rule on the deficit with a *long term* one on the debt[86]. Basically, the idea would be that of linking the maximum allowed deficit with the *distance* between each country's current level of debt and the reference value of the Maastricht Treaty – or, perhaps, a close value. Therefore, high debt countries, such as Italy or Belgium, should respect the 3% *upper ceiling* – or, as Fiorito (2002) has later argued, even more stringent values – while other low debt ones, such as Ireland or Finland, would be allowed to carry wider deficits without being sanctioned. Indeed, as one could find in Calmfors and Corsetti (2002), the logic would be that linking the *height* of the deficit ceiling to that of the debt – i.e. reducing debt would allow a higher deficit – may "enhance the incentives for fiscal discipline, as governments would enjoy the visible benefit of moving up a rung *after* reducing their debt". Interestingly, in Calmfors and Corsetti (2003) a further explanation of the proposal's logic is provided: as a matter of fact, the two authors add that the incentive towards fiscal discipline may be seen, to a certain extent, "a corollary to the common argument that a track record of low inflation for a central bank should increase the scope for interest rate cuts in future".
But all these considerations are not the only advantages such proposal could entail; indeed – of course if the incentive above would prove, *ex post*, concrete and effective – the two authors explain that the *debt-deficit* link would (i) imply a smaller risk of pro-

[86] The other aspect of the proposal, a "*depoliticisation* of the enforcement of Fiscal Rules", will be examined in the next chapter, to which we refer back. Here focus is put on the Debt Sustainability problem.

cyclical policies in booms and (ii) it would mean, to the extent that the advantages of fiscal discipline become larger, that the legitimacy of fiscal rules, and thus their long run credibility, would be enhanced.

Moving to the practical aspects of the proposal, it could be implemented by setting different deficit ceilings for different debt intervals, following the scheme of Table 6 below; moreover, the basic assumption of this proposal is that "debt ratios lower than 55% of GDP[87] would permit successively deficits higher than the 3% threshold".

[87] The 55% value had been chosen for "reasons of credibility" involving France, Germany and Portugal; as a matter of fact, given that their debt ratios are nowadays close to the 60% of GDP, allowing to loosen their commitments would harm the entire aim of the proposal.

Table 6. The New Deficit Ceilings by Calmfors and Corsetti (2003)

Debt Ratio (% of GDP)	**Deficit Ceiling** (% of GDP)	**Countries in the Range**
> 55	3.0	Italy (108.7), Belgium (101.7), Greece (102), Portugal (58.1), *Bulgaria (58.1)*, France (59.3), Germany (61.8), Austria (63.0).
45 – 55	3.5	Netherlands (50.1), Sweden (51.7), *Hungary (52.9)*, Spain (53.2).
35 – 45	4.0	Ireland (35.0), UK (38.1), *Slovak Republic (39.3)*, Finland (41.9), Denmark (42.4), Poland (43.3).
25 – 35	4.5	*Czech Republic (25.6), Slovenia (27.9).*
< 25	5.0	Luxembourg (3.9), *Estonia (4.4), Latvia (16.8), Lithuania (23.6), Romania (24.6).*

Note: Accession Countries in italics.

Source: Calmfors and Corsetti (2003), *Table 1*, page 10.

Before moving to the criticisms and conclusions, two final comments on the table above seem appropriate. First of all, as the authors suggest, since accession states in general show lower debt ratios than the EU average, the rule would give them greater scope for running deficits in downturns, which may prove to be a good instrument, given that they could reduce the risk of larger cyclical swings during their transition to fully developed market economies. Second, from a procedural point of view, an aim analogue to the Rule's one may be achieved by the setting up of the so-called *rainy days funds*, already existing in the US and in Canada: the idea would be to allow using extra budgetary resources during downturns, by letting the countries with debt *under* certain thresholds[88] (i) borrow more money or (ii) transfer Government claims on the private sector directly to the funds.

4.5.3 Do We Really Have to Focus on Debt Sustainability?

According to either Pisani-Ferry (2002) or Calmfors and Corsetti (2002 and 2003), the answer should be a plain "*yes, we do*". Undoubtedly, their proposals focus on a correct concern, given that, as it has been argued many times above (i.e. see De Grauwe) it is the *mid/long term* sustainability of debts which is relevant, making a certain degree of short term flexibility both not worrying and desirable. Consequently, one should argue that something in this field should be eventually implemented, to ensure a cure to one of the current Pact's most harmful pathologies – that is its short term rigidity.

In addition, and more specifically, given the common logic of the proposals, two peculiar ideas have particularly and favourably impressed. First, the proposal by Pisani-Ferry to set up an *optional* new Pact, which would avoid the many times accused "leap in the dark", given that the SGP would remain as a sort of minimal platform, appears interesting; second, Calmfors and Corsetti's logic of taking into account each country's *relative* debt level, as a benchmark for setting the deficit target, could be an effective and transparent instrument to practically measure each country's short term room for manoeuvring.

Moving to each proposal's specific defects, it has been argued (Giudice and Montanino, 2003; Buti, Eijffinger and Franco, 2003) that some technical problems could emerge. First of all, in the case of Pisani-Ferry, that of dealing with the so-called *implicit liabilities* (i.e. already assumed liabilities, such as future pensions' funding) which are either difficult to estimate or ethereal to deal with. Second, and perhaps more crucially,

[88] Therefore, the logic would be exactly the same as the previous one.

that of *time inconsistency* between the incumbent Government's commitment to reduce debt and the following one benefiting from past efforts[89].

Furthermore, and from a very different perspective, it could be noted (Giudice and Montanino, 2003) that long run concerns are actually present – even if of course in an embryonic form – in the current European Rules; as a matter of fact, the two authors underline that either a shift towards long run sustainability issues has recently been undertaken or that some further steps ahead might be taken[90], following a perspective similar to the one by both Pisani-Ferry and Calmfors and Corsetti.

Moreover, it seems that both proposals may be considered harmful for something that stays *ahead* of each one's technicalities: a long, tormenting and dangerous negotiation process. As a matter of fact, such proposals have been, so far, the first ones really involving national interests on the table of negotiations. Indeed, given that each state would be interested in gaining as much room as possible for short term manoeuvring, sharp conflicts are likely to turn up before reaching an agreement[91] – if one could eventually be found. The idea is that countries with high debt – whose dimensions indeed show a strong *path dependency*, considering the past governments' fiscal faults in widening them – would do their best to stop any amendment of the Treaty or Pact or, even, in some way[92], any implementation of Voluntary Codes.

The final message from this debate might be therefore, that when national interests are *directly* and *endogenously* involved on the ground play of the debate on whatever kind of reform proposal, no *pareto-improving* solution could be eventually found. Indeed, it seems important to remind that, in contrast with the proposals examined in this paragraph, reforms such as, say, the introduction of a Golden Rule or of the Permanent

---

89 As a matter of fact, who could assure that an *incumbent* government would be interested in undertaking politically costly expenditure cuts/revenue increases, if the *following* one would benefit for them? Indeed, the counter-opinion by the proposals' proponents – that it is the good reputation of the incumbent virtuous government which will make it re-elected and therefore make it profiting from its own past actions – appears too unreal, considering the cruel European political cycle in recent years (see for example Buti and Van den Noord, 2003).

90 See next chapter for some proposals by the authors.

91 This is true even if the Debt Sustainability Pact would actually not require a change in the EU treaties; as a matter of fact, the possibility of finding a satisfying agreement appears weak, given the huge interests on the playground.

Balance one would not be so dangerous, as they would raise strategic but *EU-wide* problems, rather than harming the European intergovernmental *equilibria*.
In conclusion, therefore, it seems that, again, two theoretically interesting proposals have to be put aside, while, however, trying to remember the relevance of the key suggestions they provide.

4.6 A "Good Quality Finance Rule"

"The Stability and Growth Pact and the Lisbon Strategy need each other – and Europe needs both". This is the charming *incipit* of a brand-new proposal by Padoan and Rodrigues (2004), which focuses on the relationship between fiscal discipline and growth. Essentially, their idea is that the SGP and the Lisbon Strategy should become "mutually reinforcing pillars of the European Economic Strategy" and that EU member states should have "to consider how to achieve such a virtuous interaction".
More specifically, their analysis' architecture is based on the assumption that the Pact has delivered "great benefits to the EU economy" and should therefore be both strengthened and made more effective. Furthermore, if they believe that it is enough flexible to accommodate critical situations, they argue that it is underperforming, "regarding the limited contribution to medium and long term growth". Consequently, they focus on this topic, adding that a stronger and more credible Pact would sharply increase confidence and would thus enhance the European Economy's growth potential. Using the authors' own words, "the relationship between fiscal discipline and growth is bi-directional and mutually reinforcing".
Moreover, Padoan and Rodrigues' proposal is aimed at exploiting the contribution of Public Finances to growth by focusing on their composition, given that the individual items in the budget have different impact on growth and, indeed, attention should be put on those enhancing growth potential: typically, the most *growth-virtuous* elements are identified with education and research[93], as the Lisbon Strategy underlines. Indeed, taking this aspect into account, the authors say it would be possible to use the *discipline*

---

[92] As the experience of battles, vetoes and *political retaliations* of the debates to approve the EU's Draft Constitution, in December 2003, may witness.

element of the SGP – its incentive structure – in order to redirect resources towards more growth-enhancing elements while, at the same time, reinforce the implementation of the Lisbon Strategy[94].

In fact, they propose a Rule – which would *complement* the Pact's existing ones – based on two pillars: a *budget* pillar and a *debt* one.

Pillar One: The Budget

The idea is that, while keeping the actual framework (i.e. the 3% *upper ceiling* and the *close-to-balance-or-in-surplus* medium term objective), the budget items "would count differently towards the SGP's requirements". More specifically, either measures supporting *factor accumulation*[95] would be partially or totally excluded from the computation of the deficit or, conversely, measures that depress long run growth would not be admitted towards meeting the Pact's requirements. Of course, such classification would be supported by "a careful identification of those budget items that should be considered as supporting factor accumulation", made by either an assessment by EuroStat or by a strengthened surveillance by the European Commission.

Pillar Two: The Debt

Given that, according to the authors, "reinforcing the role of Public Finances to support growth should not go to the detriment of debt sustainability", the measures suggested above should be implemented in a *scenario* compatible with a "sufficiently rapid" decline of the Debt/GDP ratio for countries with a ratio above the 60% or with a dynamic not harming the threshold for the others.

---

93 Either on the expenditure or on the revenue side – i.e. fiscal incentives to increase them.

94 Indeed, according to the authors, given the convergence of the aims, also the objectives of the *European Initiative for Growth* should be considered and translated into concrete actions, "in support of the Lisbon Strategy".

95 See Table 2 at page 12 of Padoan and Rodrigues (2004) for some specific examples on measures enhancing long term growth potential. A random overlook, as an example: expenditures such as *"faster internet researchers and students", "fiscal incentives for private investment in R&D", "fostering entrepreneurship and innovation", "investing in human capital"* and so on.

Operationally, measures to insure such goal could be found for example adopting sound indicators to assess long term debt sustainability (taking into account, for instance, also the *implicit liabilities*) or “an explicit minimum debt reduction requirement”.

Moreover, and in conclusion, adopting this kind of *growth-enhancing* rule “would not need nor imply to modify the SGP” – even if it remains highly questionable how such a *de facto* hard change in the computation of the deficits and in the entire logic of the Pact would be affecting the current Pact’s shape.

4.6.1 Criticisms on the rule

Recognising the innovative and, to a certain extent, even revolutionary *ego* of the proposal, for the first time putting the issue of growth at the core of the debate on the SGP, it seems that it would lead to very high implementation difficulties.
First of all, even if the authors stress that “it not just an extended Golden Rule”, considering the presence of the *human capital* dimension, its shape and its practical consequences appear very close to the latter ones’, with all the negative implications that we examined above[96]. Second, the Good Quality Finance Rule appears internally inconsistent considering the likely contrast arising from the goals of two pillars: as one could easily imagine, the incentives to relax the deficits targets, at least in the short term, following a more than predictable “investment wave”, would be in sharp contrast with the debt sustainability objective. Third, even adopting an optimistic scenario of a well-deigned and well-implemented rule, it seems that the surveillance framework (especially considering the idea of making EuroStat responsible for the auditing process) would not fit the necessities of such a complex rule, leaving space for both creative accounting and for *free riding* behaviours.
In conclusion, it seems that the proposal correctly puts some light on important and still too low-considered issues such as the European growth potential and the scope for implementing, in some way, growth-enhancing measures; moreover, and very plainly,

96 See Paragraph 1 for the huge number of criticisms against the introduction of a golden rule.

while recognising this merit, it seems that at the same time less politically-dangerous and more practical measures[97] to hit the targets should be found and then implemented.

4.7 Conclusions

With the aim of being as synthetic as possible, the paragraph is divided intro three brief key points; the perspective adopted is a wide one, referring back to each proposal's assessment for specific considerations and criticisms.

1. A *Pareto-Improvement*?: As it was argued at the beginning and throughout the chapter, reform proposals carrying *pareto-improvements*[98], with regards to the current situation, were looked for. Actually, no proposal has proved able to pay significant economic, political and procedural "dividends", since it has been shown, case-by-case, that a dangerous *leap in the dark* is likely to follow the adoption of every reform plan. Indeed, this position is justified by the belief that, even if (i) each Pact's reform embodies, indeed, an interesting feature and if (ii) some *first best* theoretical solutions have been found (most notably[99], Casella (2001)), they dramatically lack of both feasibility and simplicity.

2. Focus on Feasibility and Simplicity: In the troubled political context of the current *intergovernmental* Europe[100], focusing on these issues appears crucial and, ultimately, the very key for finding a way out from the Pact's nowadays *impasse*. Given this constraint, it seems that what a reform proposal should tend to is, first of all, to be

---

97 Once again, the *European Initiative for Growth*, which will be carefully examined in the next chapter, may *ex ante* appear interesting.

98 See also Buti, Ejffinger and Franco (2003) for a similar kind of judgement on the assessment.

99 To a certain extent, also the *logic* of Salvemini (2003) could be seen as "*first-best* oriented". See Paragraph 1 for greater details.

100 Even if of course one should not sacrifice the *good reasons* of economics for the *ambiguous necessities* of politics, carefully considering the current EU political climate appears either useful or inevitable. For instance, while reading the interview-styled book by Gianfranco Fini (*"The Upcoming Europe – The destiny of the continent and the role of Italy"*, Fazi editore, 2003), former Vice-President of the EU Convention, a certain *ex ante* difficulty of having a courageous communitarian approach has been found; moreover, the consequent failure in drafting the EU Constitution has *ex post* confirmed such controversy and has, in our opinion, sent a precise political message to policymakers and economists involved in any kind of reform proposal affecting European rules or institutions.

feasible and, secondly, efficient in tackling some *specific* issues, rather than opening huge debates on new problems[101]. Besides, and complementarily, solutions entailing too complex mechanisms or too *brave* proposals[102] should be avoided, even though theoretically appealing; indeed, the reason is that in contrast with what Lars Calmfors is used to say – that it is the politicians' hostility against a reform proposal which makes it both good and desirable –, a certain political and institutional neutrality appears as the key factor for success.

In conclusion, a broad message from the chapter may be that a solution able to cope with the Pact's problems should be found either (i) *without* changing the current EU rules or (ii) *without* affecting the nowadays' precarious institutional as well as political *equilibria*.

3. Lessons from the Reform Proposals: Before moving on to next chapter, it seems correct to recall the three most relevant issues that have dominated, in our opinion, the debate on the mainly significant reform schemes.

First, tackling the short term rigidity of the Pact, as well as its asymmetric nature and the pro-cyclical bias it embodies, appears as both a highly debated and strongly aimed feature[103]; thus, finding a mean able to cope with such critical element is mandatory. *Second,* there is a growing concern on introducing more emphasis on *long term growth-enhancing* measures (referring to both physical and human capital); it seems that rather than the old fashioned – and indeed controversial – Golden Rule, proposals following the same objectives but *via* less critical ways should be considered and quickly implemented. *Third*, given that the reasons adduced by Wyplosz (2002) to set up a more independent fiscal policy framework appear interesting – even if his following proposals have appeared unsatisfying – the topic should be further addressed, to find out whether a device able to improve the system, while not touching the delicate institutional architecture, may be eventually found.

---

101 Again, the perspective – even if not all the contents, for reasons examined in next chapter – of the analysis by Buti, Ejffinger and Franco (2003) is followed.

102 Such as, for instance, the clever but too much intricate proposal by Casella (2001) or, perhaps, the interesting but too *arithmetic-based* one by Buiter and Grafe (2002).

103 Indeed, nearly all the proposals presented above address the problem, in some way. Most notably, Wyplosz (2002), Casella (2001) and Pisani-Ferry (2002) have provided specific proposals in the field.

5 The way ahead to the reform of the Pact

5.1 Introduction

After having addressed what happened to the Pact in its early years of life and analysed what main reform proposals have been put forward to cope with its weaknesses, the agenda is now set to recall the latest events that eventually shaped the new Pact at the Spring Council Meeting of March 22nd, 2005.

The aim of this section is therefore twofold: on the one hand, to provide a link with Chapter 2, dedicated to the Pact's breaching, in order to give the complete picture about the events that reshaped it; on the other, it is intended to critically appraise whether such changes have been carrying some improvements in its structure and functioning.

The chapter is structured as follows: first of all, the events related to the European Court of Justice ruling are recalled (paragraphs 2 and 3); then the Commission's reform proposal is examined and critically discussed (paragraphs 4 and 5); after that, the debate towards the final agreement on the new Pact is dealt with, both from the point of view of the political debate (paragraph 6 and 7) and of the new draft document agreed (paragraph 8); finally, the section ends with an attempt to give an opinion on the new set of rules (paragraph 9).

5.2 The European Court of Justice ruling

Soon after the EcoFin decision to suspend the sanctioning mechanism of the SGP was taken on November 25th, 2003[104], the Commission announced its willingness to react and to take an action at the European Court of Justice (ECJ) level. On January 27th, 2004, the Commission fiercely denounced (a) "the Council's failure to adopt the decisions

[104] See chapter two above for details.

recommended by the Commission" and (b) "the conclusions adopted by the Council itself" (ECJ, 2004). Following expedited procedure requested by the Commission, in the next months the ECJ took its decisions and on July 13th issued its "Judgement in Case C-27/04", based on two different, although linked, statements.

Regarding the first issue, the Court found that *"where the Commission recommends to the Council that it adopt decisions such as those at issue in the present case and the required majority is not achieved in the Council, a decision, even an implied one, does not exist for the purposes of the Treaty".* Consequently, the Court found that failure by the Council to adopt the decisions recommended by the Commission *"does not constitute an act challengeable by an action for annulment"* and it declared that such part of the action was *"inadmissible"*.

Regarding the second part of the action, though, the ECJ took a much different position. As a matter of fact, the Court declared that the action is *"admissible in so far as it is directed against the conclusions* [of the Council]*"*, since the Council *"cannot depart from the rules laid down by the Treaty or those which is set for itself in regulation n.1467/97* [the SGP] *"*. The logic followed by the Court was that with regards to the suspension of the excessive deficit procedure, the EU regulations *"set out exhaustively the situations in which the excessive deficit procedure was to be held in abeyance"*, and indeed, those regarding France and Germany were not as such. In addition, the Court observed that the Council couldn't have modified – as it did, *de facto* – the Commission's recommendations *"without being prompted again by the Commission, which has the right of initiative in the excessive deficit procedure"*. Therefore, at the end of its ruling, the Court solemnly "*annulled the Council's Conclusions of November 25th, 2003"*.

Indeed, the two rulings above appear very interesting, as they provide two different messages to all players involved in such a complicated game. First, and most importantly, the ruling made once again evident that the Pact had been plainly breached, given that the Council had made an *illegal* conclusion, in the sense that it was against the rules that itself, as a political body, had approved some years earlier. No doubt, therefore, that some kind of action of reform or amendment would have been required to restore the integrity of the rules. Second, and maybe less evidently, the Court sharply reaffirmed the roles, hierarchies and fields of influence among the EU institutions: with its first statement, the ECJ implicitly restated the institutionally superior role of the Council over the Commission, when dealing with the implementation of the EU rules. As a matter of fact, provided that of course the Council's conclusion were illegal, there was no way for the Commission to *impose* any of its recommendations.

Again, the political side of the events emerges, when realising that dealing with the EU Council means dealing with a political institution that, in the end, keeps the last word on those delicate topics. To put it with the sharp words of The *Economist*: "…though it falls to the Commission to police the Pact (…), it falls to the Council to enforce it. If a qualified majority of ministers do not back the Commission's proposals, the proposals have no force[105]".

5.3 The debate on the reform moves forward

The days after the ECJ ruling were characterised by a relatively calm and reflective mood among both EU officials and Institutions and National Governments.

The Commission welcomed the Court's ruling, saying it confirmed the Commission's view as to the respective role of itself and the Council as regards the application of the Stability Pact (European Commission, 2004). Indeed, it couldn't avoid mentioning that, being the Council's conclusions annulled by a formal act of the Court, *"the situation prevailing at the moment* [was] *the one of the 24th November"*, the day prior to the Council's breaching of the Pact. Moreover, the Commission further declared its intention to formulate more specific proposals for *"strengthening and clarifying the implementation of the Stability and Growth Pact[106]"* and for *"improving Economic Governance in the European Union"*.

On the other hand, the ECOFIN silently *"took note"* of the ECJ judgement, *"welcomed the clarification rendered on the interpretations of both the provisions of the Treaty and on the excessive deficit procedure and the SGP, clarifying the respective roles of the*

[105] The Economist, *"If only they could be all like Luxembourg"*, July 13th 2004.
[106] This would have been the name of the Commission's own proposal fro amending the SGP. See next paragraphs for details.

Commission and the Council[107]", and further committed itself to participate in the prospective discussions on the reform of the Pact to be held in Autumn.

The debate on the reform of the Stability Pact was now officially open, with the Commission having the right – and the obligation, in a way – to draft its own proposal as a first introduction to the following discussion.

5.4 The Commission's Proposal

On September 3rd 2004, the reform proposal of the European Commission was ready to be disclosed.

As Joaquìn Almunia, the Economics and Monetary affairs Commissioner, put it, the aim of the whole document was "*to introduce more economic rationale in the implementation of the SGP and while strengthening surveillance and enforcement (…). They* [surveillance and enforcement] *aim to support macroeconomic stability, ensure sustainable public finances and contribute to the improvement of the European growth potential and the realisation of the Lisbon Agenda*[108]".

Indeed, the logic of the work was centred on the idea of refocusing the Pact on the basis of its past weaknesses, while keeping the whole rules-based framework simple and transparent[109]. Above all, the Commission's point of view was centred on the belief that the Pact and Treaty should have kept on being the backbone of the entire EU fiscal framework and few minor changes would have assured significant improvements.

The communication (European Commission, 2004b) was centred on four core issues[110], which will be dealt with separately: (a) Placing more focus on long term sustainability; (b) Allowing for more country specificity in defining the *close-to-balance or in surplus* objectives; (c) Providing more consideration of economic circumstances and developments in the implementation of the excessive deficit procedure; (d) Ensuring earlier actions to correct inadequate budgetary developments.

---

[107] *"Statement of Ministers of Economy and Finance on Case C-27/04, Commission vs Council"*, 13th July 2004.

[108] Deroose and Langedijk (2005).

[109] It seems sensible to mention that in the document itself it is stated that "surveillance and coordination of the fiscal policies have to be applied in a fair and consistent way and have to be understood by the EU public opinion" (European Commission, 2004b).

5.4.1 More focus on Long-term sustainability

The main idea beneath the Commission's first point is that of ensuring the achievement of prudent debt ratios among the EU partners before the impact of population ageing fully takes place. Indeed, as the document explicitly says, the Pact "could clarify the Treaty's basis on which the Treaty provision of a *satisfactory pace* of debt reduction should be assessed", i.e. the amendment of the Pact could have moved towards making the debt criterion of the Treaty operational.

The logic would have been to set a satisfactory pace of debt reduction, while taking into account country-specificities and growth conditions when dealing with the single national cases, to ensure sustainability of public finances in the medium-long run. More specifically, as the document states, "in defining a satisfactory rate of debt reduction (…) it should be taken into account the need to ensure prudent debt ratios before the ageing of populations takes place fully, the country specific initial debt levels and potential growth conditions". Therefore, in contrast with a mechanistic approach – such as the Treaty's mere setting of the 60% Debt /GDP ratio as convergence value – this would imply leaving judgement in the process (Deerose and Langedijk, 2005) and thus enhancing the economic rationale of the rules when dealing with debt sustainability.

5.4.2 More country-specific circumstances for the *close-to-balance* clause

The starting point of the discussion around the somehow hot issue of country-specificities is that with a European Economy characterised by an increasing economic diversification, "uniform objectives for all countries do not appear appropriate and lack economic rationale" (European Commission, 2004b).

The Commission thus proposes that medium term objectives – i.e. *the close-to-balance or in surplus* clauses – could be differentiated on the basis of a country's initial debt level and expected growth potential, varying them from small surpluses in member states with

[110] The four main points were actually complemented by two further policy aspects that will be briefly introduced at the end of the four major issues.

excessive debt levels and modest growth potential to small deficits in countries with low debt levels and sufficiently dynamic economies (Deroose and Langedijk, 2005).

Nonetheless, the document stresses that there is of course a trade-off between the economic appropriateness of the objectives' definition and the related complexity: therefore, when defining the guidelines to set up the *close-to-balance* objectives for each member state, such danger would have to be carefully considered to ensure operational effectiveness.

5.4.3 More consideration of economic circumstances for the EDP

The proposal moves from the belief that the SGP introduced a high degree of automatism in the application of the excessive deficit procedure (EDP), which *ex-post* proved to be unsatisfactory[111] and which would be likely to become increasingly discretionary if left as such (Deroose and Langedijk, 2005). Thus, taking more into account the economic circumstances in the implementation of the EDP would strengthen its economic rationale and would overcome the already over-stretched interpretation of the rules.

The Commission provides the two following guidelines to resolve this complicated issue. First, it proposes to cater for *"prolonged periods of sluggish growth"* through the *"exceptional circumstances clause"*, since it argues that the case of slow but still positive economic growth "is not fully taken into account in the current EU fiscal framework[112]". Operationally, this would mean redefining the concepts of "severe economic downturn", "abruptness of the downturn" and "the loss of output relative to past trends", in order to clarify in some way that a protracted slowdown of the economy would not automatically put the EDP in movement.

Second, it suggests to allow for country-specific elements in the enforcement *of the correction* of the excessive deficits – i.e. to introduce some elements of flexibility and country specificity in the definition and completion of the adjustment path. The idea is that "one-size-fits-all deadlines for the correction of excessive deficits have great limitations, because they do not allow distinguishing between countries with different

[111] See previous paragraphs for further details.

[112] Of course, an immediate link with the events related to the recent breaching of the Pact can be done. The logic is exactly to tackle those situations of *impasse* because of the lack of explicit regulatory provisions.

cyclical developments and different debt levels" and that such framework could lead to pro-cyclical adjustments to meet the deadlines or, even worse, to recurring to one-off operations . In conclusion, the EDP, when activated, would be sort of *tailor-made* in terms of timing and pace of adjustment and of adaptation the country's actual economic and financial condition.

5.4.4 Earlier actions to correct inadequate budgetary developments

In the fourth and final issue, the preventive side of the new rules' system is placed in the spotlight, with the aim of tackling two of the main weaknesses of the pact: its historically well known asymmetric working over the cycle and the related absence of incentives to adopt prudent policies in good times. Therefore, the proposal is centred on putting more pressures on a "*renewed* and *shared* commitment" by member states to conduct symmetrical fiscal policies over the cycle and to achieve surpluses in good times.
Operationally, the Commission could issue early-warnings directly and in more timely manner – i.e. also in good phases of the cycle and not necessarily when the deficits are close to the 3% reference value – to ensure that actions are taken to correct inadequate budgetary developments. In addition, also the Broad Economic Policy Guidelines (BEPGs) could be strengthened and used more effectively to address the issue of "good policy in good times", as the Commission calls it.
Once again, emphasis is put on the issue of a more efficient and less mechanical application of the rules by the EU Institutions, leaving room for strengthening the Pact's preventive side.

5.5 Assessing the Commission's approach

Considering the proposal in its full *ampleur*, it seems that the intention of the Commission is that of slowly switching the budgetary surveillance process of the Pact from a pure mechanistic – and actually biased – screening of the deficit patterns to a more sound and economically appropriate surveillance process over national public finances. Indeed, together with an increased focus on judgement rather than automatisms and procedure, the proposal does make sense and seems to address many, if not all, of the weak points of the old Stability Pact.

As a matter of fact, the first two issues – long term debt sustainability (in the light of population ageing) and country specificities and a-synchronies – are of paramount importance in the nowadays European framework and, even more importantly, are of paramount evidence, as many authors have been noting for a long time. Indeed, if we consider the long term sustainability being the core long run objective of a multilateral surveillance on public budgets and if we admit that the highly fragmented scenario among the European economies and public finances is the *starting point* of every policy decision, no proposals could have been more welcomed. Maybe a good way to witness the extreme evidence and urgency of the two phenomena above would be to cite once again *The Economist,* for its great lucidity on the issues: "Europe is ageing much faster than the new world (…). This process will test European budgets to the limit, carrying a big rise not only in pensions but also on health and long term care. Adverse demographic change may push up public spending by between 5 and 8 percentage points of GDP in the EU-15 by the end of 2040. It will be hard for taxpayers to foot next bill[113]". And on country diversities: "The divergence in the growth rates of the Euro members conceals much larger, and widening, differences in the components of economic growth: changes in consumption, investments, government spending and net exports. (…)Indeed, many speculate that despite efforts to converge in advance via product markets, services and financial markets, countries entered the single currency from very different starting points. Once in the Euro, these differences have paved the way for increasing differences also in real growth"[114].

In addition, also on the other two issues (i.e. the consideration of economic circumstances and the early action by the Commission), although more operational than theoretical, one could argue that the proposals certainly move in the right direction, balancing a more realistic approach towards the treatment of periods of slow growth together with more focus on the action in good times. Again, the "second couple" of proposals appears well designed and sensible as much as the first one.

---

113 From *The Economist*, "Old Europe", October 2nd, 2004.
114 From *The Economist*, "Growing Apart", October 2nd 2004.

However, and as the *ex-post* assessment of the events that followed the proposal may witness, the appropriateness of the Commission's proposal left two big issues open: first of all, whether the policy suggestions on reforming the Pact would have been considered appropriate and relevant, as well as operationally feasible, by the politicians involved in the decision-making process and second, whether they would have been *enough* to tackle the many problems of the Pact and of the EU public finances. The following events would have been saying something about the first issue, the second being too difficult to address with the process of change still *in fieri*.

5.6 The reactions by the EU politicians: a new agenda

As quickly as the 10th September, the first political reaction turned up under the shape of the "Statement by Ministers of Economy and Finance on the Stability and Growth Pact[115]", which followed the informal EcoFin meeting on that date. In a very concise way, the EU Ministers welcomed the Commission's proposal as a "good basis for discussion"; they further declared themselves unwilling to accept "a watering down of the Pact", but rather long of a strengthening and clarification of the rules.
In addition, the declaration stressed the necessity to further analyze four elements, two being in line – although not strictly identical – with the Commission's proposal (i.e. focusing more on Debt Sustainability and building up of a more effective preventive arm of the Pact), while two addressing other issues: the critical analysis of the Excessive Deficit Procedure, in terms of measures taken *versus* economic forecasting errors, and the setting of right policy priorities towards the achievements of the Lisbon Agenda objectives. Again, ministers asked the Commission to further work on such elements and *de facto* did not take any immediate relevant position nor decision. The debate was then ready to move on towards its most relevant part: the necessary agreement that had to be reached at the Council level. Nonetheless, it seems – at least as a minor comment at this early point of the stage – that already from the beginning Ministers were on the one hand in accordance with the logic of the Commission's ideas, but on the other somehow sceptical to explicitly tie themselves to politically difficult or nationally-dangerous

[115] Declaration appeared on the Danish EU Presidency website, *www.EU2004.nl*, on September 10th 2004.

proposals. An emblematic example could be the immediate Italian embarrassment when dealing with the proposed operationalisation of the Debt Criterion, which would have implied sharp consequences for a country with a Debt/GDP ratio above 100%. Again, the wait-and-see attitude was perhaps a way to avoid some country-related dangers and to move forward the debate towards more favourable conditions from the national perspective.

The following Autumn and Winter was then fully dominated by the debate among politicians of different countries, and, in a minor measure, the EU institutions. Economic Ministers and even Prime Ministers were trying to impose their specific point of views and to find some political agreement with other parties, in order to form "blocks" in the Council; very interestingly, the debate switched from what it should have dealt with – i.e. the economics of the new Pact – towards more *back-of-the-yard* issues, as many declarations to newspapers and television by politicians witnessed.

5.7 Germany attacks, France and Italy follow, Juncker enters the debate

On 18th January, 2005 German Chancellor Gerard Schroeder wrote a letter ("A framework for a stable Europe[116]") to The Financial Times that would have become very important in the whole reform process. As a matter of fact, the Chancellor made clear in front of the European public opinion that times had dramatically changed from 1997, when Germany was designing the strict stability-oriented shape of the Pact. He actually wrote: "Reform of the EDP will be the cornerstone. Strategies of reform must reflect the fact that it is not just a Stability Pact but also a Growth Pact (…). Whether a Fiscal Policy is 'right' and promotes stability and growth equally cannot be measured solely by compliance with the deficit reference value of the 3% of gross domestic product. This indicator is *inadequate* to deal with the complex realities of fiscal policy".

Mr. Schroeder couldn't have been clearer: it was time to loosen the binding ties of the Pact and to realise that growth was becoming the new keyword of the deal. Again, the

---

116 From The Financial Times, *"A Framework for a Stable Europe"*, letter by German Chancellor Gerhard Schroeder on Tuesday, 18th January 2005.

Chancellor wrote: “This is the starting point for the reform concept (…), a concept that enhances the growth component of the Pact”. He also added his views on the correct recipes to achieve this outcome:

(a) As regards to the EDP, he said “mandatory criteria” would have to be used by the Commission and the Council “to review whether an EDP should have been instigated against an EU member” and he added that “the most significant criterion would be the pursuit of a sound policy for growth and employment, for which the country should be given leeway”;

(b) Concerning the other criteria to block the EDP, he added that structural reforms should have been taken into account, given their short-term impact on growth and on budgets, together with the Macroeconomic factors, recalling the Commission’s proposed provisions for the “sluggish economy”, in contrast with the issue of the “downturn” from the old Pact.

(c) Finally, he added a very particular element that had to be taken into account: the “specific burdens borne by member states” – i.e. the costs for German reunification, what he called in a very diplomatic way “payments promoting solidarity among people within the and between EU nations”.

In addition, he even stressed that member states failing to meet the criteria above should in any case be given “the time they need to gear their policies to the goals of a higher growth” and, above all, at the end of the letter he underlined that “*more respect* should be given to EU members’ *primary competence* over economic and fiscal policy”.
The German Chancellor, despite the formalisms of his letter, was eventually very clear: there was no way out form the reform process other than relaxing the rules, move the priorities from stability to growth – which should be in fact two different issues and which should in reality require different instruments to be achieved – and, above all, get the EU institutions make a step back when coming too close to national sovereignty.

At the same time, France and Italy were active on the debate, too. The French Finance Minister, together with President Jacques Chirac, was increasingly pressing for taking out the defence spending from the calculation of the deficit ratio, while the Italians were debating for either avoiding the definition of a "satisfactory rate of reduction" in debt or taking out the research spending, following a sort of *golden rule* applied to the investments in intangibles.

The framework was thus very composite, despite one common element: that national priorities were in spotlight. At this point, though, trying to take into account of each national demands would have been "a recipe for endless political battles", as The Financial Times put it[117]. At such point of the debate, Mr. Jean Claude Juncker, Luxembourg's Prime Minister and chairman of the EcoFin Council[118], tried to recap all the proposals and to commit himself to put an end to the debate no later than the scheduled meeting of the European Council in Brussels on March 22nd and 23rd. He also put forward his own proposal of reform, in an attempt to get the full accordance among the EU Finance Ministers and to close the deal with some advance, having secured an agreed solution a the informal Eurogroup meeting on March 9th in Brussels[119]. But eventually that did not happen, since the 16 points[120] of his proposal – indeed a masterpiece of diplomacy, although possibly too complex – were not fully accepted by the other actors of the debate, most notably France and Germany, despite containing "mitigating factors[121]" that were designed in order to please them. The final solution would have had to arrive at the Spring Council Meeting, where at the end consensus must have been found among all 25 EU members.

---

117 From The Financial Times, *"New rules, please"*, editorial comment, January 18th 2005.

118 An also more effectively known as *Mr.Euro* for his remarkable experience on the Pact's issues.

119 The opinion comes from an article on The Financial Times, *"EU attempts to reform stability pact before summit founders",* March 9th 2005.

120 Indeed, it is even difficult to exactly outline the content of the so famous "16 points". As a matter of fact, the negotiation strategy was based on getting full approval on the proposals by a series of one-to-one discussions, intended to build consensus before public disclosure. As far as the economic newspapers can be trusted as reasonable sources, it can only be said that the proposal was trying to further fine tune the Commission's proposals together with the new issues on the debate, in an attempt to give further concessions to France and Germany requests of loosening (Il Sole 24 Ore, *"Concessioni a Francia e Germania"*, 8th March 2005).

121 From The Financial Times, *"Rift over 'final' revision of fiscal pact"*, March 9th 2005.

5.8 The new Stability and Growth Pact

“Juncker has achieved an historical agreement”: that was how Thierry Bréton, French Finance Minister welcomed[122] the successful attempt of Jean Claude Juncker to issue a final draft of the new Pact. President Juncker was actually able to get the full consensus of the EcoFin members in a document that took the name of *“Improving the implementation of the Stability and Growth Pact”* (European Council, 2005) and that was officially agreed at the extraordinary EcoFin Meeting of the 21st March and eventually submitted to the European Council of the 22nd for the full approval.
Shaped by a compromise-driven approach and characterised by the balancing of delicate political equilibria rather than a sound economic rationale, the document nonetheless presents itself with a certain unity and addresses the most relevant topics in a rather comprehensive way. An attempt to go into its details is presented below.

5.8.1 Backbone of the proposal

The core part of the document, where all the amendments are dealt with, is anticipated by two pages aimed at introducing the rationale beneath them and, as one could argue, they are of crucial importance for a full comprehension of the change that was about to reshape the Pact. The backbone of the reform plan seems to be built on two core premises: *first*, that a solution to the trade-off between the need of more judgement and policy discretion, on the one side, and of simplicity and transparency of the rules, on the other, must be found; *second*, that the whole economic exercise of redesigning the Pact must be aware of the necessary “respect of the prerogatives of national governments in determining their structural and budgetary policies” (European Council, 2005) – i.e. national sovereignty.
Thus the EU Ministers were fully aware of the first big issue – discretionarity *versus* rules that immediately reminds back to the *Wyploszean* debate on rules versus institutions – and indeed, stating this premise, it seems clear that they were willing to move towards more discretionarity and elasticity, given the shape of the Pact’s rules *pre*-reform. With such an intention, nobody would have ever expected a strong commitment towards

keeping the rules-mechanism working at its ordinary pace, but rather a deliberate move towards flexibility and, perhaps, rules overstretch.

Ministers were furthermore very much concerned about the *dogma* of national sovereignty: there seems to be no doubt that the Gerhard Schroeder's approach[123] towards the reform of the Pact had made some very motivated fellows among the EU politicians, and Jean Claude Juncker couldn't have ignored such widespread tendency: *inter-governmentalism* was back and EU institutions had to step back.

In addition, an finally, the issue of growth is also emphasised in that set of premises: as a matter of fact, with a statement like "the instruments for EU Economic Governance need to be better interlinked to enhance the contribution of fiscal policy to economic growth and to the realisation of the Lisbon Strategy", ministers de facto declared themselves more concerned about the growth issue, rather than the stability one: again, the franco-german intention to insert a growth aspect into a set of rules centred on stability was at the end agreed among all the EU members. The stability Pact was about to loose its (too) tight stability orientation, but perhaps moving towards a (too) lax one.

5.8.2 The amendments

From a more factual point of view, the document articulates its reform proposals on three directions: (a) Improving Governance and strengthening ownership of the rules; (b) Strengthening the preventive arm of the Pact; (c) Improving the implementation of the excessive deficit procedure.

(a) Improving Governance: the first issue addresses the delicate field of the EU rules legitimacy, that has to be improved taking into account both "the Commission's and Council's respect of the Member States responsibilities to implement the policies of their choice" and "the Member States necessity to comply with the recommendations of the Council". The document thus proposes a primary sub-set of agreed measures[124]: first, to

[122] From The Financial Times, *"Juncker achieves 'small miracle' as deal rewritten"*, March 22nd 2005.
[123] See previous paragraphs for a comment on Gerhard Schroeder's letter to The Financial Times.
[124] Indeed, a careful reading of the first set of proposals reveals more and more the *moral suasion-style* of the amendments themselves: they cannot be considered as true changes to the rules, being on the contrary only a set of "agreed intentions" or "agreed moral commitments".

enhance “cooperation and communication” among institutions, member countries and general public, in order to strengthen the ownership of the rules at all levels; second, to improve “peer support and peer pressure”, making public the EU Institution’s positions at all appropriate stages of the procedures of the Pact”; third, to enhance “complementarity among national and EU rules”, by giving “incentives for national rules to support the objectives of the Pact” and by discussing “with due caution” the implementation of “existing national budgetary rules in the Stability and Convergence Programmes[125]”.
The second sub-set of proposals deals with the reliability of macroeconomic forecast and of fiscal statistics, which is seen as a key element for an effective improvement of Governance. Undeniably – as the document correctly underlines – the proper implementation of the fiscal framework relies “crucially” on the “quality, reliability, timeliness and cautiousness” of fiscal and macroeconomic statistics. Therefore member states should move forward in two directions: *first*, they should affirm their “commitment to produce high quality and reliable budget statistics” and to guarantee a “full transparency of such statistics” and, *second*, they should base their budgetary projections on “realistic and cautious macroeconomic forecasts”, taking into careful account the “common external assumptions[126]” and placing “greater emphasis on sensitivity analyses” and on the explanation of “the divergences”, if any, “between national and EU forecasts”. Also in this case the whole reform effort is based on the somehow intangible concepts of “mutual cooperation” and “commitment” among Member States and EU Institutions.

(b) Strengthening the Preventive Arm: here is the part of the agreed reform that, together with the third one (point c below), is perhaps the most significant in terms of real amendments to the old SGP. The whole strategy of reinforcing the preventive arm of the Pact is indeed built on “the broad consensus” that periods of growth above trend should be exploited for budgetary consolidation, to avoid pro-cyclical policies. In addition, the document reaffirms the necessity to set a renewed commitment at the Member States

[125] Here maybe the only *direct* and *concrete* consideration from this sub-set of proposals turns out: the disincentives stemming from the impact in the fiscal framework of “certain ESA95 accounting and statistical rules”, that the Council suggests considering and possibly reforming. But also in this case the proposals are timid and remain linked to intentions and commitments than to real changes.

level to take “the necessary budgetary action necessary to converge towards the *close-to-balance or in surplus* objective and respect it”.

And here comes a *first* proposal, in fact previously suggested by the Commission[127], to differentiate the Medium Term Objectives (MTO, i.e. the *close-to-balance* clauses) for individual member states, to take into account the diversity of economic and budgetary positions and developments among the EU members. More specifically, the idea is to differentiate the MTOs on the basis of “the current debt ratios and potential growth, while preserving sufficient margin below the reference value of -3% of GDP” and this could be translated into a range[128] of the MTOs themselves “between -1% of GDP for low debt, high potential growth countries and balance or surplus for high debt, low potential growth ones”. Interestingly, the proposed reform links such differentiation of the MTOs with the implementation of “major structural reforms in the areas related to the ageing of populations and of the increase in employment”: in such cases, and in any case “every four years”, MTOs objectives “could be revised”, in order to reflect new patterns of development in government debt, growth potential and fiscal sustainability.

A *second* proposal affects instead the adjustment path to the MTOs: as a matter of fact, to ensure a more symmetrical approach to fiscal policy over the cycle, Member states should commit at a European Level to “actively consolidate public finances in good times” and thus should “use unexpected extra revenues for deficit and debt reduction”. In addition, after underlying that the adjustment effort should be higher in good times and “could be more limited in bad ones”, the document states that the annual adjustment in cyclically adjusted terms, net on one-off and other temporary measures should “pursue an annual pace of 0,5% of GDP as benchmark”. With such a provision, indeed, the whole mechanism should become less biased and increasingly counter-cyclical, but again, a closing clause makes the whole picture less clear: as the draft says, “States that do not follow the required adjustment path – i.e. the 0,5% of GDP – will *explain* the reasons for the deviation in the annual update of the Stability and Convergence Programmes”; once again, flexibility is guaranteed, at the expense of clarity and uniformity. Finally, such

---

[126] Those of the European Commission Services.

[127] See European Commission (2004b).

[128] The document also states that such values should be intended “cyclically adjusted, net of one off measures”; again, this introduces margins of discretionarity and manoeuvre.

proposal recalls also the focus on structural reforms, that "will be taken into account[129] when defining the adjustment path to MTOs, (…) allowing a temporary deviation from this objective", but at the same time still ensuring the respect of the 3% reference value for the deficit. Still, such special attention, as the Council calls it, towards structural reforms which translates itself into real amendments of the rules shows on the one hand the willingness to approve the new growth-oriented nature of the Pact and, on the other, to promote such politically difficult schemes among EU partners.

(c) Improving the implementation of the EDP: the reform of the excessive deficit procedure couldn't of course be avoided, given that from a formal point of view it was the cause of the Pact's breaching in 2003. Therefore, the third "direction" of the reforming activity was correctly fully dedicated to this delicate issue. However, the whole reforming framework is that of a neat loosening of the rules, which can be showed easily both from a policy-oriented point of view and from a more analytical, procedural one. The first is quickly explained by citing the very beginning of the part dedicated to the EDP, where the Council underlines that the purpose of the EDP "is *to assist* rather than *to punish*, and therefore to provide incentives for Member States to pursue budgetary discipline". Indeed, with a former EDP that was specifically designed to be "the stick" of budgetary discipline, it seems very much clear what intention was behind such policy declaration.

Moreover, the analytical changes of the EDP are articulated in the following fields: (i) the definition of the "exceptional and temporary clause" and (ii) of "all other relevant factors"; (iii) the focus on systemic pension reforms and debt sustainability and, finally, (iv) the deadlines extensions in particular cases.

First of all, the Council agrees to revise the particular exceptions foreseen in articles 104(2)(a) and (b) of the Treaty, under which the EDP is technically suspended. The proposal is to allow block the EDP *also* for excess above the reference values of the deficit which prove to be "exceptional and temporary[130]" in relation to a period of

[129] Actually the document underlines that "only major reforms which have direct long-term cost-saving effects and a verifiable positive impact on public budgets" will be considered. However, no specific details are provided on how to appraise such necessary attributes.

[130] Of course the deficit should also remain "close to the reference value".

"negative growth rate or from an accumulated loss of output during a protracted period of very low growth relative to potential". Thus, with the new rules not only the old rule of the 2% annual fall in the Real GDP could be exploited to block the EDP (the "severe economic downturn" of Article 2(2) of Regulation 1467/97, i.e. the Pact), but also in cases of multi-annual sluggishness of the economy – exactly what happened in the years 2001-2003. Therefore, with the new rules, the Pact would *not* have been breached in November 2003.

Second, the document clarifies that the notion of "all relevant factors" (Article 104(3) of the Treaty), following a direction of relaxing the rules, in the sense that before activating the EDP procedures, the Commission should "appropriately reflect developments in the medium term economic and budgetary position of the member state", and in particular, "potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon Agenda". Furthermore, the Council's proposal suggests to give "due consideration" also to any other factors that are relevant to assess "in qualitative terms" the excess over the reference values and to also give "special consideration" to budgetary efforts aimed at "increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieve European Policy goals, notably the unification of Europe if it has detrimental effect on the growth and fiscal burden of a Member State[131]".

Third, the new EDP and the following correction path, if any, would have to deal with the "net cost of the reform of publicly managed pension systems", in order not to punish with the EDP countries which had implemented virtuous structural reforms in the pension field. More specifically, particular consideration of the net cost of the reforms would be given in the initial "five years" after the introduction of a reform themselves. In addition, and in line with the Commission's thoughts[132], given the increased focus on debt sustainability – rather than on short term deficit monitoring, the whole "debt surveillance process", and thus *also* the EDP, should be strengthened by applying the concept of debt values "sufficiently diminishing and approaching the reference values at a satisfactory pace" . In practical terms, this provision would mean two different, although related,

[131] This of course recalls the German Chancellor's intention to get a favourable treatment of the expenditures borne by West Germany for the German reunification. At the end, he thus won his political battle and succeeded in having his requests written in the new SGP text.

things. One the one hand, that the EDP should take into account also the efforts made to diminish debt, thus adding another relaxing clause in the interpretation of the EDP itself, and on the other, that no "satisfactory pace of debt reduction" would have to be reached, as the Commission was asking in its latest proposal: the new pact thus encompasses both more laxity in the EDP implementation and less austerity in debt reduction.

Fourth, and finally, two key deadlines related to the EDP setting up and implementation are relaxed, as many EU members were asking. Most importantly, the new Pact would provide the possibility in "special circumstances[133]" to set "the initial deadline for correcting an excessive deficit one year later", and therefore the second – and not, as it was previously, the first – year after its identification and thus normally the third after its occurrence. In addition, the document explains that deadlines for correction could be "revised" and "extended, if unexpected adverse economic events with major unfavourable budgetary effects occur during the EDP". But the provisions go even further: "if effective actions were taken [by the member state] in response to previous recommendations and unforeseeable growth developments, the procedure would *not* move the next steps". The EDP becomes thus so flexible that it doesn't any more look like a repressive measure, as it should at least in theory be.

5.9 Conclusions: a new phase into the EU rules

Having introduced the new rules, a comment on their achievements and drawbacks seems now necessary, in order to provide a clear judgement on the issue .

Rather than proposing a unique comment covering the whole aspects of the proposal, we try to split comments and observations into different parts, with the aim to make our opinion both more clear and more articulated.

[132] See European Commission (2004b).

[133] When defining the special circumstances, the text is rather vague: "a balanced overall assessment of the factors mentioned in the report under Article 104(3) of the Treaty".

5.9.1 Benchmarking with the Commission's Proposal: many discrepancies

Obviously, attention has to be initially placed on *how* the new Pact reflects the Commission's proposal it should have taken inspiration from. And here the judgement is very disappointing, given that we also expressed a favourable opinion on that reform proposal as well as underlying logic[134]. If we check which of the four main points[135] proposed have been inserted into the Council's final draft, we actually find that only points two and three – i.e. diversification of the MTOs and the amendment of the EDP – have been developed comprehensively. But it seems not surprising to find out that these two are the ones originally thought as directed towards a loosening of the Pact, while the commitments in terms of "debt sustainability" (point 1) and of "early action" (point 4) have been eventually left aside or addressed only in indirect ways[136].

It seems thus rather clear that the intention of European Commissioner Joaquìn Almunia – *to introduce more economic rationale in the implementation of the SGP, while strengthening surveillance and enforcement*[137] – has been clearly biased towards a different approach, aimed at explicitly loosening some provisions while refusing to tightening others, which at the end have been only recalled under the elusive shape of the "political commitments". Therefore, if we strictly follow this perspective the new set of rules appears very much close to the concept of the "watering down of the rules", so many times criticised by EU officials and politicians but at the end perversely followed. As a matter of fact, being of course clear that the Pact needed a more intelligent, less mechanical and more flexible functioning, the changes moved *only* in that direction, lacking the necessary *fine-tuning* and balancing of both tight and lax provisions that could have made the rules really more effective.

---

[134] See paragraph 5.5. above for details.

[135] They are: (a) Placing more focus on long term sustainability; (b) Allowing for more country specificity in defining the "close-to-balance or in surplus" objectives (MTOs); (c) Providing more consideration of economic circumstances and developments in the implementation of the excessive deficit procedure; (d) Ensuring earlier actions to correct inadequate budgetary developments. See above for details.

[136] It may be useful to recall the large number of political commitments in terms of "sustainability of public finances" and of more efficient "governance" and "ownership of the rules" that is present in the document. Very straightforwardly, one could say that they *de facto* remain commitments and good intentions, that the recent sad story about the Pact developments may well define as not relevant when facing real situations with national economic and political interests under threat.

[137] That was the main intention of the Commission's Proposal, firmly declared by the Economics Commissioner. See paragraph 5.4 above.

5.9.2 Economic rationale is weak, if not absent

If we adopt a more strict economic perspective, the agreed draft seems to lack of that economic rationale it was looking for from the very beginning of the debate.

As a matter of fact, the necessary introduction of elements of flexibility and country specificity into the new rules (and, specifically, the diversification of the MTOs and the amendments of the EDP) is *not* accompanied by provisions other than commitments for a better Governance and Ownership of the Rules, on the one hand, and for a great focus on the preventive measures to ensure sustainability, on the other.

But commitments and cooperative solutions, as literature suggests, tend to be biased and to give leeway to failures if they are not supported by the necessary incentives. And, very straightforwardly, the new Pact heavily lacks them, because of two complementary reasons: *first*, the negative incentives (i.e. the menace of the EDP and of the sanctioning mechanism) have proved weak[138] and no significant effort has been made to restore their power and credibility, apart from political commitments; *second*, the positive incentives cannot arise, in an EU dominated by fiscal free-riding by some states and by an already present and relatively established monetary stability (the presence of the strong Euro).

Indeed, the EU fiscal framework has moved from a balanced "stick and carrot" situation in the run up to EMU – when the heavy efforts by member states to correct their fiscal imbalances were supported by the objective of benefiting from the introduction of the Euro (Costello, 2001) – towards a more fragmented, post-Euro framework, in which the incentives for consistent fiscal behaviours over the cycle have disappeared and political solutions have come back.

Furthermore, and in conclusion, as Bini Smaghi suggested in late 2004[139], "creating incentives for greater budgetary adjustment in good times is one of the changes [*that would have been*] necessary to make the SGP more effective. That is not easy, however"; as a matter of fact, as soon as the *carrot* of the Euro has been eaten the motivations to

[138] The breaching of the Pact in October 2003 had proved that the EDP was under the control of the Council, which at the end had blocked it unilaterally; in addition, given the relaxation of the deadlines and steps of the EDP carried forward with the new rules, it seems sensible to declare the EDP as unable to exert the necessary pressure to discipline fiscal behaviours.

[139] See Bini Smaghi (2004), "*What went wrong with the Stability Pact?"*, Department of the Treasury, Italian Ministry of Economy and Finance.

keep in place the *stick* tend to disappear, if no other *carrots* are found. And, indeed, the goal of stability among European Public Finances is a public good that is certainly subject to free riding, being a politically costly *carrot* to be achieved.

5.9.3 The growth concern is *per se* correct, but in fact misleading

Even at the early stages of debate on the reform of the Pact, the issue of growth was indeed very discussed, given the bad situation that was characterising the EU economy in the years 2001-2005, dominated by a severe slowdown.

Definitely, amendments aimed at avoiding the pro-cyclicality of the rules and their inappropriate role of "growth killer" were needed into the new Pact, and the consensus was broad on this issue (see among others Bini Smaghi, 2004 or Deerose and Langedijk, 2005). In particular, some kind of space for manoeuvre in times of very low growth had to be inserted in the framework of the EDP, in order to avoid the negative spillovers of corrective measures on already precarious situations; and, to a certain extent[140], the reform of the EDP acted in the correct direction. But here ends the good news about the reformed Pact.

In fact, the issue of growth is *misused* in many points of the Council's document in order to set the case for a growth-oriented Pact, which, according to our opinion, is an economic nonsense. As the founding fathers of the Pact may actually recall, the Stability and Growth Pact was instead originally intended as a purely Stability Pact, in the sense that its economic rationale was rooted into the goal of ensuring the long term sustainability of Public Finances in the context of a Monetary Union. No growth intention was embedded into the agreement, despite the name – that was intentionally designed to raise its political acceptability among EU partners, given its strict stability orientation. Again, if it seems sound to open the way towards a more intelligent Pact that *does not* constitute an obstacle in the struggle for achieving higher growth and growth potential, it seems also incorrect to introduce elements of growth into the very rationale of a stability-driven set of rules.

[140] However, it might be also argued that the reform of the EDP gave too much consideration for this issue, given that from a theoretical perspective the correct functioning of the automatic stabilisers would have been sufficient with such phenomenon. But, again, the political priorities shaped the debate in a different way.

Therefore, when the document stresses that the new rules should be aimed at "better responding to the shortcomings experienced so far through greater emphasis on *economic* developments (…)" and that the "instruments for EU economic governance need to be better *interlinked,* in order to enhance *the contribution* of fiscal policy *to economic growth* and support progress towards realising the Lisbon Strategy", it deliberately mixes the expansionary needs of the growth-oriented policies with the prudence of stability-oriented ones. But such interference, in our opinion, lacks economic rationale and even political realism: how will a member state be able to be blamed for too expansionary and pro-cyclical policies if they are part of the draft document itself?
In our opinion, and in conclusion, the issue of growth is addressed in the wrong place and in the wrong manner. As a matter of fact, as in a company or a bank the sustainability of the liability side of the balance sheet (i.e. creditworthiness) has to be granted to both creditors and shareholders by specific requirements and periodical assessments that are separated from the decisions on the assets' side[141] (i.e. growth prospects), it seems clear that also in the case of governments the logic should be the same: the Stability Pact covers the sustainability issues, while the national policies and the Lisbon Agenda deals with the growth aspects[142].

5.9.4 Politics, and not Economics, play the key role

The whole new Pact shows a very simple, but indeed tricky, weakness: it follows political pressures, more than economic ones. Our idea is in fact that, even if also at the time of its birth in 1997 the Pact was certainly shaped by the then German political intentions of being protected against "importing" fiscal laxity from the other EU

[141] The only link being of course that they should not be so much restrictive to compress too much the growth prospects of the entity. Again, the link with the Pact seems perfectly fitting: one thing is avoiding too much limits on the growth prospects, another one is deliberately *mixing* two different disciplines with two different *raison d'etre*.

[142] It seems interesting to cite the words of Mario Monti, from the Financial Times *("Toughen up the reform agenda and make it count"*, March 22nd 2005), recalling such misunderstanding of different set of priorities within the EU framework: "Europe has a much more worrying 'deficit' in competitiveness than in budgetary discipline. By concentrating on the Pact rather than on the Lisbon agenda, politicians have highlighted a basic shortcoming in the EU's overall policy approach". Therefore, if Mr. Monti correctly underlines the necessity to boost the growth-oriented policies of the EU framework, he does not suggest to mix them with the ones related to sustainability and stability issues. He instead adds that "Enhancing

members, now the political forces that eventually drafted the final document were more worried about strictly *political* concerns and equilibria, rather than economic reasons. As a matter of fact, if in 1997 the danger was fiscal instability and loss of control over the national currency (the D-Mark), now the founding members of the EU, France and Germany, seem more worried about the political embarrass that would follow any kind of action at the EU level against their "fiscal choices" as it was about to happen in late 2003. In addition, it appears clearly in few points of the document that leeway is given to strictly *political* issues, masked beneath the veil of economic considerations, and in particular in two cases. First of all, the Council's proposal to give "special consideration" to budgetary efforts aimed at "increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieve European Policy goals[143]" perversely gives leeway to the request of the German Chancellor of taking into account national peculiarities – although totally unrelated with the economic rationale of fiscal surveillance mechanisms. Second, also the deliberate intention of not inserting any kind of specific operalisation of the debt criterion of the Treaty, as requested in the Commission's proposal, reflects only the struggle by the Italian representatives to avoid any penalisation of their structural debt position, burdened by a Debt/GDP ratio over 100%.

Therefore, and in conclusion, with a new Pact shaped more by political equilibria of such kind rather than real economic drivers, no independent observer could be fully happy with the changes eventually implemented.

competitiveness and growth remains largely a national objective", i.e. an objective outside the logic and the provisions of the Stability and Growth Pact.

[143] This of course recalls the German Chancellor's intention to get a favourable treatment of the expenditures borne by West Germany for the German reunification. At the end, he won his political battle and succeeded in having his requests written in the new SGP text.

.

References

Economic Papers and Publications

Amtenbrink F., De Haan, J. and Sleijpen O.C.H.M. (1997), “Stability and Growth Pact: Placebo or Panacea?”, *European Business Law Review*.

Artis, M.J. (2002), “The Stability and Growth Pact: Fiscal Policy in the EMU”, in F.Breuss, G. and S. Griller (eds.), *Institutional, Legal and Economic Aspects of the EMU,* Springer, Wien-New York.

Balassone, F. and Franco, D. (1999), “Public Investment in the Stability Pact Framework”, in Bordignon, M., and Da Empoli, D. (eds), *Concorrenza Fiscale in un' Economia Internazionale Integrata*, Franco Angeli, Milano.

Balassone, F. and Franco, D. (2000), “Public Investment, the Stability Pact and the Golden Rule”, in *Fiscal Studies*, Vol.21, n.2, 2000.

Balassone, F., Franco, D. and Zotteri, S. (2002), “”Fiscal Rules: Indicators and Underlying Statistical Frameworks”, Banca d' Italia, *mimeo*.

Barro, R.J. (1979), “On the Determination of Public Debt”, *Journal of Political Economy*, vol.87.

Beetsma, R. (2001), “Does the EMU need a Stability Pact”, in Brunila A., Buti M. and Franco D., *The Stability and Growth Pact – The Architecture of Fiscal Policy in EMU*, Palgrave, 2001.

Beetsma, R. and Bovenberg, A.L. (1998), “Monetary Union Without Fiscal Coordination May Discipline PolicyMakers”, *Journal Of International Economics*, n.45.

Blanchard, O. and Giavazzi, F. (2004), “Improving the SGP through a proper accounting of Public Investment”, *CEPR DISCUSSION PAPERS n.4220*.

Bovenberg, A.L. and Kremers, J.M. and Masson, P.R. (1991), “Economic and Monatary Unionin Europe and Constraints on National Budgetary Policy”, *IMF Staff papers n.38*.

Brunetta, R. and Tria, G. (2003), “Il Patto di Stabilita' e Crescita: Regole Fiscali da Cambiare”, in *Economia Italiana*, n.2, May-August 2003.

Buchanan, J.M. (1997), “The Balanced Budget Amendment: Clarifying the Arguments”, *Public Choice*.

Buiter, W.H. (2001), “Notes on a ‘Code for Fiscal Stability’”, *Oxford Economic Papers*.

Buiter, W.H., Corsetti, G. and Rubini, N. (1993) “Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht”, in *Economic Policy*.

Buiter, W.H. and Grafe, C. (2003), “Patching Up the Pact – Some suggestions for Enhancing Fiscal Sustainability and Macroeconomic Stability in an Enlarged European Union”, *CEPR Discussion Paper 3496*.

Buiter, W.H. and Kletzer, K.M. (1991), „“Reflections on the Fiscal Implications of a Common Currency“, in Giovannini A., Mayer C. (eds), *European Financial Integration*, Cambridge University Press.

Buti, M., Eijffinger, S. and Franco, D. (2003), “Revisiting The Stability and Growth Pact: Grand Design or Internal Adjustment?”, *European Commission – Economic Papers,* n. 180.

Buti, M. and Giudice, G. (2002), “Maastricht’s Fiscal Rules at Ten: an Assessment”, *Journal of Common Market Studies*, 40(5).

Buti, M. and Martinot, B. (2000), “Open Issues in the Implementation of the Stability and Growth Pact”, *National Institute Economic Review*, 174.

Buti, M. and Sapir, A. (2002), “EMU in the Early Years: Differences and Credibility”, in Buti, M. and Sapir A. (eds), *EMU and Economic Policy in Europe – challenges for the Early Years*, Edward Elgar, Cheltenham.

Buti, M. and Suardi, M. (2000), “Cyclical Convergence or Differentiation? Insights from the first years of EMU”, *Revue de La Banque*, n.2-3.

Buti, M. and Van den Noord, P. (2003), “Fiscal Policy in EMU: Rules, Discretion and Political Incentives”, paper presented at the conference on *“Rethinking Economic and Social Preferences”*, Madrid, 26-27 November 2003.

Cabral, A. (2001), “Main Aspects of the Working of the SGP”, in Brunila A., Buti M. and Franco D., *The Stability and Growth Pact – The Architecture of Fiscal Policy in EMU*, Palgrave, 2001.

Calmfors, L. and Corsetti, G. (2003), “How to Reform Europe’s Fiscal Policy Framework”, *mimeo*.

Casella, A. (1999), “Tradable Deficit Permits: Efficient Implementation of the Sability and Growth Pact in Europe”, *Economic Policy*, n.29.

Casella, A. (2001), “Tradable Deficit Permits”, in Brunila A., Buti M. and Franco D., *The Stability and Growth Pact – The Architecture of Fiscal Policy in EMU*, Palgrave, 2001.

Chiari V.V. and Kehoe P.J. (1998), “On the Need For Fiscal Constraints in A Monetary Union”, *Federal Reserve Bank Of Minnesota, Working Paper589*.

Coricelli, F. and Chada, B. (1994), "Fiscal Constraints and the Speed of Transition", *CEPR Discussion Paper 998*.

Corsetti G. and Roubini N. (1993), "The design of Optimal Fiscal For Europe after 1992", in Torres, F. and Giavazzi, F. (eds), *Adjustment and Growth in the European Moetary System*, Cambridge University Press.

Costello, D. (2001), "The SGP: How did we get there?", in Brunila A., Buti M. and Franco D., *The Stability and Growth Pact – The Architecture of Fiscal Policy in EMU*, Palgrave, 2001.

Crowley, P.M. (2003), "Do we Really Need a Stability and Growth Pact for EMU?", paper presented at the NYU conference in London *"Building European Economic Government: Revisiting the Rules?"*, London, 25-26 April 2003.

Eckl, C. (1997), "States Broaden the Scope for Rainy Day Funds", presented at the *National conference of State Legislatures*, November 1997.

Eichengreen, B. and Wyplosz, C. (1998), "The Stability Pact: More than a Minor Nuisance?", in Begg, D. *et al.* (eds), *EMU: Prospects and Challenges for the Euro*, Blackwell, Oxford.

European Commission (1990), "One Market, One Money", *European Economy,* n.44.

European Commission (2000), *Public Finances in EMU – 2000*, European Economy, Reports and Studies.

European Commission (2001), *Public Finances in EMU – 2001*, European Economy, Reports and Studies.

European Commission (2002), *Public Finances in EMU – 2002*, European Economy, Reports and Studies.

European Commission (2003a), *Public Finances in EMU – 2003*, European Economy, Reports and Studies.

European Commission (2003b), *A European Initiative for Growth*, Final Report to the European Council, COM (2003) 690 Final.

European Commission (2003c), "Autumn 2003 Economic Forecasts", European Economy, n.5/2003.

Euroepan Commission (2004), "Commission's Statement on the Court of Justice Ruling relating to the excessive deficit procedure", IP/04/897.

European Commission (2004b), *"Strengthening economic governance and clarifying the implementation of the stability and growth pact"*, Communication from the Commission to the Council and the European Parliament.

European Council (2005), *"Improving the Implementation of the Stability and Growth Pact"* , ECOFIN Council report n.104 endorsed by the Council on 22nd March 2005.

Fatàs, A. (2000), "Intranational Labour Migration, Business Cycles and Growth", in Gregory D.Ness, Eric. V. Wincoop, *"Intranational Macro-Economics"*, Cambridge University Press.

Fatàs, A. and Mihov, I. (2002), "The Case for Independent Fiscal Policy", *preliminary version*.

Federal Reserve Bank of Boston (2003), "Preparing for the Storm: Rainy Day Funds in New England", in *New England Fiscal Facts*, n.31, August 2003.

Fisher, J.and Giudice, G.(2001), "The Stability and Convergence Process", in Brunila A., Buti M. and Franco D., *The Stability and Growth Pact – The Architecture of Fiscal Policy in EMU*, Palgrave, 2001.

Gali, J. and Perotti, R. (2003), "Fiscal Policy and Monetary Integration in Europe", *NBER Working Paper 9773*.

Giovannini, A., Spaventa, L. (1991), "Fiscal Rules in the European Monetary Union: a No-Entry Clause", *CEPR Discussion Paper 516*.
Giudice, G. and Montanino, A. (2003), "Il Patto di Stabilita' e Crescita", *versione preliminare preparata per la sezione "Parole Chiave" della Rivista di Politica Economica*.

Gonzalez, C. Y. and Paqueo, V.B. (2003), "Social Sector Expenditures and Rainy Day Funds, *World bank Policy Research Working Paper n. 3131*.

Hallet, H. A. (2003), "Stability and Growth in Europe: Towards a Better Pact", in *Monitoring the European Integration*, n.13.

HM Treasury (1998), *The Code for Fiscal Stability*, November 1998.

IMF (2001), *Fiscal Policy and Macroeconomic Stability*, May 2001.

Inman, R.P. (1996), "Do Balanced Rules Work? US Experience and Possible Lessons for the EMU", *NBER Working Paper Series, 5838*.

Lucas, R.J. and Stokey, N. (1983), "Optimal Fiscal and Monetary Policy in an Economy with Capital", *Journal of Monetary Economics*, vol.12.

Melitz, J. (2000), "Some Cross-Country EvidenceAbout Fiscal Policy Behaviour and Consequences for EMU", *European Economy*, n.2.

McDougall Report (1977), "Report of the Study Group on the Role of Public Finance in European Integration", vols.I-II, Commission of the European Community.

Kilpatrick, A. (2001), "Transparent Framework, Fiscal Rules and Policy Making Under Uncertainity", in Banca D' Italia, *Fiscal Studies*, 2001.

Kenen, R. (1969), "The Theory of Optimum Currency Areas: an Eclectic View", in Mundell, R and Swoboda, A. (eds), *Monetary Problems of the International Economy*, University of Chicago Press.

Knight, B. and Levinson, A. (1998), "Fiscal Institutions in the US", *mimeo*.

Knight, B. and Levinson, A. (1999), "Rainy Day Funds and State Government Savings", *National Tax Journal, LII*.

Kopits, G. (2001) "Fiscal Rules: Useful Policy Framework or Unnecessary Ornament?", in Banca d' Italia, *Fiscal Studes*, 2001.

Kopits, G. and Craig, J. (1998), "Transparency in Government Operations", *IMF Occasional Paper n.158*.

Kopits, G. and Symanski, S. (1998), "Fiscal Policy Rules", *IMF Occasional Paper*.

Oxley, H. and Martin, J.P. (1991), "Controlling government Spending and Deficits: Trends in the 80s and Prospects for the 90s", *OECD Economic Studies*, vol.17.

Majocchi, A. (1998), "Dai Vincoli di Maastricht al Patto Di Stabilita': Un Sentiero Stretto Per la Politica Fiscale", in *La Finanza Pubblica dall' Aggiustamento degli anni 90' alle Riforme Per l' Unione Monetaria*, Societa' Italiana di Economia Pubblica.

Majocchi, A. and Rey, M. (1993), "A Special Financial Support Scheme in Economic and Monetary Union: Need and Nature", in European Commission, *The Economics of Community Public Finance,* European Economy – Reports and Studies, n.5.

Modigliani, F. *et al*. (1998), "Manifesto Contro la Disoccupazione nell' Unione Europea", in *Moneta e Credito*, vol.51.

Pisani-Ferry, J. (2002), "Fiscal Discipline and Policy Coordination in the Eurozone: Assessment and Proposals", paper prepared for the *Group of Economic Analysis* of the European Commission, April.

Restoy, F. (1996), "Interest Rates and Fiscal Discipline in a Monetary Union", *European Economic Review*, vol.40.

Sapir, A. (2003), "An Agenda For Growing Europe – Making the EU System Deliver".

Stark, J. (2001), "Genesis of a Pact", in in Brunila A., Buti M. and Franco D., *The Stability and Growth Pact – The Architecture of Fiscal Policy in EMU*, Palgrave, 2001.

Texas House of Representatives (2002), "Cash-Strapped States Tap Rainy Day Funds", *House Research Organisation*, n.77 – March 2002.

Turrini, A. (2003), "Public Investment and the EU Fiscal Framework", European Commission, *mimeo*.

Padoan, P.C. and Rodrigues, M.J. (2004), "A Good Quality Finance Rule", *The European Policy Centre*.

Perotti, R. (1999), "Fiscal Policy in Good Times and Bad", *Quarterly Journal of Economics*, vol.114.

Salvemini, M.T. (2003), "Politiche di Bilancio e Regole Europee: Una Riflessione Aperta", in *Economia Italiana*, n.2, May-August 2003.

Sobel, R. and Holcombe, R. (1996), "The Impact of Rainy Day Funds in Easing State Fiscal Crises During the 1990-1991 Recession", *Public Budgeting and Finance, n.3,* Fall 1996.

Von Hagen, J., Hallet, A.H. and Strauch, R. (2001), "Budgetary Consolidation in EMU", *DG ECFIN Economic Papers.*

Wyplosz, C. (1991), "Monetary Union and Fiscal Policy Discipline", *CEPR Discussion Paper n.488*.

Wyplosz, C. (2002), "Fiscal Policy: Rules or Institutions?", paper prepared for the *Group of Economic Analysis* of the European Commission, April.

Monographs, Text Books and Manuals

Apel, E. (2000), "European Monetary Integration 1958-2000", Routledge – London.

Bosi, P. (2000), "Corso di Scienza delle Finanze", Il Mulino – Bologna.

De Grauwe, P. (2000), "The Economics of Monetary Integration", Oxford University Press, fifth edition.

Fini, G. (2003), “L’ Europa che Verra’ – Il Destino del Continente e Il Ruolo dell’ Italia”, a cura di Fusi, C., Fazi editore.

Krugman, P. and Obstfeldt, M. (1994), “International Economics”, 3rd edition, Harper Collins Publishers, New York.

Molle, W. (1997), “The Economics of European Integration – Theory, Practice, Policy”, Ahgate Publishing – England, 3rd edition.

Nascimbene, G. (2003), “Comunita’ e Unione Europea – Codice delle Istituzioni”, G.Giappichelli Editore – Torino, 3a edizione.

Nugent, N. (2001), “Governo e Politica dell’ Unione Europea”, Il Mulino – Bologna, 3a edizione.

Stuart Mill, J. (1848), “Principles of Political Economy – Books IV and V”, Penguin Classics, Penguin Editions – London.

Tesauro, G. (2003), “Diritto Comunitario”, Cedam – Padova, 3a edizione.

Zanghi’, C. (2000), “Istituzioni di Diritto dell’Unione Euopea”, G.Giappichelli Editore - Torino, 3a edizione.

Newspaper and Web Articles

Ascari, G. (2003), “Un’ Autorita’ per la Politica Fiscale”, www.lavoce.info

Blanchard, O. and Giavazzi, F. (2002), “La Crisi della Germania e le Riforme del Patto di Stabilita’”, www.lavoce.info

Calmfors, L. and Corsetti, G. (2002), “A Better Plan for Loosening the Pact”, from “The Financial Times”, November 26th 2002.

Cipolletta, I. (2003), “Il Patto e La Crescita”, www.lavoce.info

Fiorito, R. (2003), “I Parametri del Patto di Stabilita’: Intoccabili, Cervellotici o Incompleti?”, www.lavoce.info

Montanino, A. (2002), “La Riforma del Patto: le Proposte della Commissione”, www.lavoce.info

Munchau, W. (2003), *“Flexible Rules For Europe, Strictly Enforced”*, The Financial Times, 26th February 2003.

Perotti, R. (2003), *“Un Patto Senza Ambiguità”*, www.lavoce.info

Ponzellini, M. (2003), *"Per Crescere Meglio – Un piano per le nuove forme di finanziamento delle infrastrutture"*, in Dossier Europa, September 2003.

Tanzi, V. (2003), "L' Importanza del Patto", www.lavoce.info

The Economist, *"Growing apart"*, October 2nd, 2004.

The Economist, *"If only they could be all like Luxembourg"*, July 13th 2004.

The Economist, *"Loosening Those Bonds"*, July 7th 2003.

The Economist, *"Old Europe"*, October 2nd 2004.

The Economist, *"Reforming the Stability and Growth Pact?"*, October 24th 2002.

The Economist, *"Restoring Europe's Smile"*, October 24th 2002.

The Economist, *"Stability or Instability"*, Charlemagne, November 6th 2003.

The Economist, *"Unstable and Incredible"*, November 27th 2003.

The Financial Times, *"A Framework for a Stable Europe"*, letter by German Chancellor Gerhard Schroeder, January 18th 2005.

The Financial Times, *"EU may yet pay the price of not playing by the rules"*, November 26th 2003.

The Financial Times, *"EU attempts to reform stability pact before summit founders"*, March 9th 2005.

The Financial Times, *"Juncker achieves 'small miracle' as deal rewritten"*, March 22nd 2005.

The Financial Times, *"New rules, please"*, editorial comment, January 18th 2005.

The Financial Times, *"Rift over 'final' revision of fiscal pact"*, March 9th 2005.

The Financial Times, *"Surprise at Eichel's 'emotional response'"*; November 26, 2003.

The Financial Times, *"Toughen up the reform agenda and make it count"*, letter by the former European Commissioner's Mario Monti, March 22nd 2005.

Consulted Websites

www.cepr.org

www.ceps.be

www.chicagofed.org

www.economist.com

www.econpapers.hhs.se

www.econ.worldbank.org

www.econ.yale.edu/corsetti/euro

www.europa.eu.int

www.europarl.eu.int

www.ft.com

www.italianieuropei.it

www.lavoce.info

www.nber.org

www.newyorkfed.org

List of Tables, Boxes and Charts

Tables:

1. “Growth and Budgetary Positions in EMU (Years 1998-2001)” page 30.
2. “National Budget Balances (Years 2000-2001)” page 32.
3. “Growth and Budgetary Positions in EMU (Years 2002-2003)” page 34.
4. “National Budget Balances (Years 2002-2003)” page 35.
5. “The EU Fiscal Rules against Kopits-Symanski’s Criteria” page 39.
6. “The New Deficit Ceilings by Calmfors and Corsetti (2003)” page 96.

Boxes:

1. “Discretionary Fiscal Policy or Automatic Stabilisation?” page 46.
2. “Composition of Fiscal Adjustment in Years 1993-2000” page 50.
3. “The *Permanent Balance Rule*” page 83.

Charts:

1. “The SGP’s sanctioning mechanism” page 23.
2. “Main trends in EU aggregate Deficit, Revenues and Expenditures” page 26.
3. “Composition of Fiscal Adjustment, 1993-2000, in Points of GDP” page 51.