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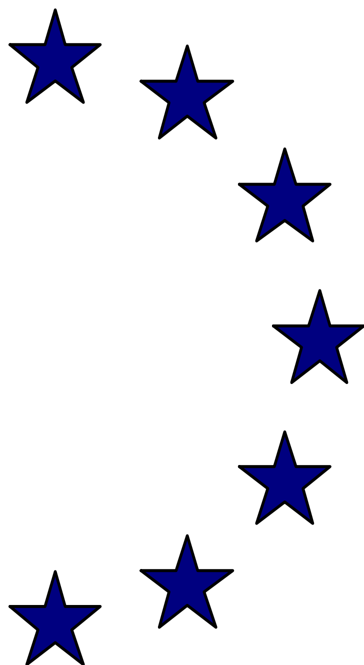

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The framework for fiscal policy in EMU: What future after five years of experience?

by

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Abstract [*]

This paper reviews the first 5 years of experience with the working of the EMU framework for fiscal policy in EMU. It is argued that the balance with the fiscal framework of EMU so far is mixed. The EMU framework has contributed to avoid large fiscal imbalances in EU Member States and has evolved continuously to deal with a number of budgetary challenges connected to the conduct of fiscal policy and the assessment of budgetary developments in the short, medium and long run However, problems with the implementations of the rules have emerged, and the ownership of the framework should be re-established. We argue in favour of further improvements within the framework of the Treaty along the following directions: increased focus on debt and sustainability; better account of country-specific factors in the definition of medium-term targets; better enforcement of the rules; improved implementation of the excessive deficit procedure; greater account of the Lisbon goals in applying the EMU framework for economic policy co-ordination and budgetary surveillance.

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1. INTRODUCTION

At the moment of launching the EMU project with the Maastricht Treaty[1], there was a widespread recognition that certain formal co-ordination mechanisms were needed among the countries sharing the single currency. Unsustainable budgetary positions in a Member State were seen as a major threat to overall monetary stability, as ultimately they could lead to either default or debt monetisation. There was also a recognition that fiscal policy in EMU had an important role to play in cushioning the effects of national cyclical developments, given the loss of the monetary and exchange rate instruments. These considerations led to Treaty requirements on Member States to keep deficit and debt levels below agreed reference values of 3% and 60% of GDP respectively. In 1997 these were supplemented by the Stability and Growth Pact (SGP) which called on countries to achieve budget positions of 'close to balance or in surplus' and reinforced multilateral surveillance and enforcement.

The framework for the co-ordination of fiscal policies in EMU sparked considerable controversy prior to the launch of the euro, and indeed it proved also to be a contentious issue in the first five years of EMU. Expectations on the prospects for fiscal developments were mixed at the start of EMU. On the one hand, the risk of a loosening of fiscal policies had been highlighted, partly on the grounds of fiscal 'adjustment fatigue', partly due to the perceived weakening of incentives to run sound policies, as the carrot of euro-area membership would no longer exist. On the other hand, there were also concerns related to the fact that most Member States joined EMU with deficit levels just below the 3%-of-GDP reference value and/or with debt levels above 60% of GDP; it was argued that this could lead to a deflationary bias, given the need to consolidate public finances to reach budget positions of 'close to balance or in surplus' to let the automatic stabilisers operate fully without breaching the 3%-of-GDP reference value at the same time that the newly created ECB was seeking to establish its credibility.[2]

The experience after 5 years of EMU shows that the EU framework for fiscal policy was partly effective in orienting the behaviour of fiscal authorities towards the objective of fiscal discipline. However, the concerns manifested at the start of EMU proved to be correct to some degree. Since 1999, fiscal policies lost the ambition that characterized the period of the run-up to EMU during the mid-nineties. During 1999-2000 period of high growth, fiscal authorities of many euro area countries missed the opportunity of achieving a close to balance position. During the low growth period beginning in 2001, most Member States were faced with the worsening of their fiscal positions, but a markedly contractionary fiscal stance was judged inappropriate given the weak cyclical conditions. Such deterioration in public finances manifested in some cases with deficits exceeding the 3% of GDP reference value. The application of the EDP procedures proved controversial in some occasions, and there are signs of a diminished political ownership of the SGP among Member States. Currently, the EU fiscal framework appears to be under strain, mainly due to difficulties encountered in the enforcement of the Stability and Growth Pact. Consistently, many have argued in favour of redesigning the framework for budgetary surveillance at EU level.[3] The Commission has also recently

[1] The EMU project was launched formally with the ratification of the Maastricht Treaty in 1992. The last phase of the project, the 'birth' of the euro, started on 1 January 1999, with the conversion of the national currencies into the euro, and was concluded by the physical replacement of national coins and banknotes which took place in the first weeks of 2002. In this paper, reference to Economic and Monetary Union is generally made to indicate the monetary entity (also known as the 'euro area') which exists since the 'birth' of the euro in 1999.

[2] Such view was expressed, for instance, in De Grauwe (1998).

[3] Among recent critiques and proposals on the EMU fiscal framework see, for instance, Blanchard and Giavazzi (2004), Buiter and Grafe (2002), Buti, Eijffinger and Franco (2003), Calmfors and Corsetti (2003), Fatas et al., (2003) , Pisani-Ferry (2002), Sapir et al. (2003) , Wyplosz (2002).

put forward proposals for enhancing the EU fiscal framework in such a way to strengthen its economic rationale, re-affirm the political commitment by Member States towards a rules-based system and restore the full credibility of the rules.

The remainder of this paper assesses the experience with the EMU fiscal framework during five years after the introduction of the single currency. After a retrospective examination with respect to three specific questions, the paper examines possible future changes to the fiscal framework. The major questions addressed are the following:

- Did Member States meet the agreed budgetary targets for deficits and debt set down in the Treaty and the SGP, thus ensuring the public finances are on a sustainable footing and support the single monetary policy, and did the framework help to that end?

- Did the framework for fiscal policy provide a useful basis for developing a better understanding on the appropriate conduct of fiscal policy in EMU and for addressing new policy challenges as they emerged?

- Was the framework for fiscal surveillance, and in particular the peer pressure and enforcement mechanisms of the Stability and Growth Pact (early warning recommendations, the excessive deficit procedure), robust enough to prevent budgetary imbalances from emerging, and to tackle them when necessary?

- What directions for changing the EMU fiscal framework appear to be desirable and feasible, in the light of the experience so far?

2. WERE THE DEFICIT AND DEBT OBJECTIVES MET, AND DID THE FRAMEWORK HELP TO IMPROVE THE BEHAVIOUR OF FISCAL AUTORITIES?

2.1. Where the objectives of the EU fiscal framework met?

In the first years of EMU, nominal budget balances generally improved due to buoyant cyclical conditions. A cursory look at the figures shows in fact that all Member States recorded remarkable improvements in nominal balances in 1999 and 2000 (see table 1). These developments mainly reflect the unexpected acceleration in economic growth and in financial assets prices - which substantially increased revenues - and, concerning 2000, the additional and exceptional receipts arising from the auctions of UMTS licences. However, despite the favourable economic climate in the early years of EMU, Member States failed to continue the process of budgetary consolidation evident in pre-EMU period. [4] The marked deterioration in the economy starting in 2001 quickly reversed the rosy picture of 1999 and 2000, and nominal deficits grew rapidly. After having achieved a surplus in 2000 (including UMTS proceeds), the euro-area nominal deficit climbed to 2.7% of GDP in 2003, almost ½ a GDP point higher than in 1998. While the economic slowdown is the main factor responsible for the deterioration in public finances in recent years, some of the deterioration also stems from discretionary measures. The cyclically-adjusted budget balance for the euro area in fact decreased from -1.7% in 1999 to -2.3% in 2003 (see Figure 1).

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[4] A detailed description of budgetary developments in the EU can be found in the annual Public Finances in EMU Report available at the web site: http://europa.eu.int/comm/economy_finance/publications/publicfinance_en.htm.

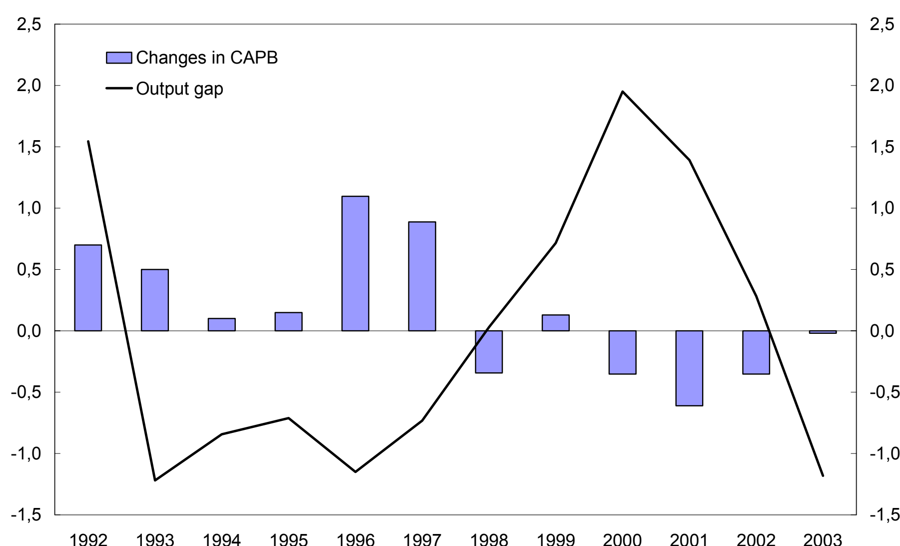
Table 1: **Nominal budget balance (as % of GDP)**

	Average 1993-98	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
BE	-3.8	-0.7	-0.4	0.1	0.5	0.0	0.2	-0.5	-0.8
DE	-3.0	-2.2	-1.5	1.3	-2.8	-3.5	-3.9	-3.6	-2.8
EL	-7.9	-2.5	-1.8	-2.0	-1.4	-1.5	-3.0	-3.2	-2.8
ES	-5.1	-3.0	-1.2	-0.9	-0.4	-0.1	0.3	0.5	0.6
FR	-4.4	-2.7	-1.8	-1.4	-1.5	-3.1	-4.1	-3.7	-3.6
IE	-0.4	2.3	2.3	4.4	1.1	-0.1	0.2	-0.8	-1.0
IT	-6.5	-3.1	-1.8	-0.7	-2.7	-2.4	-2.5	-3.2	-4.0
LU	2.4	3.2	3.7	6.3	6.3	2.7	-0.1	-2.0	-2.3
NL	-2.4	-0.8	0.7	2.2	0.0	-1.6	-3.2	-3.6	-3.3
AT	-3.8	-2.5	-2.4	-1.6	0.1	-0.4	-1.3	-1.3	-2.1
PT	-4.8	-3.2	-2.9	-2.9	-4.4	-2.7	-2.9	-3.5	-3.9
FI	-3.4	1.6	2.2	7.1	5.2	4.3	2.1	1.8	2.0
EUR-12	-4.2	-2.3	-1.3	0.1	-1.6	-2.3	-2.7	-2.8	-2.6

Note: ESA 79 up to 1994, ESA 95 from 1995 onwards. UMTS proceeds included. This amount in 2000 and in % of GDP to 2.5 for DE, 0.1 for ES, 1.2 for IT, 0.7 for NL, 0.4 for AT, 0.3 for PT and 1.1 for the euro area. In 2001, they amount to 0.2 for BE, 0.5 for EM, 0.1 for FR and 0 for the euro area.
Source: AMECO database.

By the end of 2003, seven EU countries, including five euro-area countries, maintained budget positions close to balance or in surplus. Other countries, while close to balance in cyclically-adjusted terms, had small nominal deficits, indicating that in these countries the automatic stabilisers were left to work fully. In contrast, the two major euro-area countries accounting for half of the euro-area output had nominal deficits around 4% of GDP, resulting from already high cyclically-adjusted deficits before the slowdown and from the impact of poorer growth. Portugal moved to a high deficit in 2001 (4.4% of GDP), which was subsequently reduced to just below 3% in 2003. After two years of budget balances in surplus at the beginning of the decade, a deficit in excess of 3% of GDP showed up in 2003 in the Netherlands, mainly as a result of very weak cyclical conditions.

Figure 1: Fiscal stance and cyclical conditions in the euro area, 1992-2003



Source:: Elaborations by the Commission services on the AMECO database. Note: The changes in the cyclically-adjusted primary balance are used as a proxy of the fiscal stance, while the size of the output gap proxies cyclical developments. A positive value for the fiscal stance represents a tightening of discretionary fiscal policies. UMTS proceeds are excluded in the calculation of the fiscal stance.

Debt levels in some Member States have not declined as fast as expected (see table 2). This reflects in some instances a number of operations which did not affect the deficit to GDP ratio but which increased the debt. In addition, the poor growth performance has made the contribution of the denominator effect (arising from being the debt expressed as a share of GDP) very modest in some countries.

Overall, while several smaller Member States did in fact complete the transition to budget positions of 'close to balance or in surplus', most large countries in the euro area failed to improve their cyclically-adjusted budget positions. The failure to achieve the stated goal of broadly balanced budget positions over the economic cycle may reflect some weakening in the political commitment towards the budgetary goals set down in the SGP. However, it does not imply that there has been a return to the profligate fiscal policies of previous decades. The problem can be traced back to the failure to run sound fiscal policies in the 'good times' of 1999 and 2000 when growth conditions were buoyant. Part of this may stem from governments building on the apparently very positive fiscal developments to concentrate on budgetary objectives such tax reform and redirecting government spending towards programmes considered more favourable to growth and employment creation.[5] In some cases these measures relied on rather optimistic assumption on future growth prospects and were not matched by savings elsewhere, which created the premises for budgetary difficulties as soon as the economy slowed down.[6]

Table 2: General government gross debt (as % of GDP)

	Average 1993-98	1998	1999	2000	2001	2002	2003	2004	2005
BE	130.4	119.6	114.8	109.1	108.1	105.8	100.5	97.4	94.3
DE	55.8	60.9	61.2	60.2	59.4	60.8	64.2	65.6	66.1
EL (1)	108.7	105.8	105.2	106.2	106.9	104.7	103.0	102.8	101.7
ES	63.8	64.6	63.1	61.2	57.5	54.6	50.8	48.0	45.1
FR	54.0	59.5	58.5	57.2	56.8	58.6	63.0	64.6	65.6
IE	76.3	53.8	48.6	38.4	36.1	32.3	32.0	32.4	32.6
IT	121.4	116.7	115.5	111.2	110.6	108.0	106.2	106.0	106.0
LU	6.7	6.3	6.0	5.5	5.5	5.7	4.9	4.5	3.8
NL	74.1	66.8	63.1	55.9	52.9	52.6	54.8	56.3	58.6
AT	65.5	63.7	67.5	67.0	67.1	66.6	65.0	65.5	65.3
PT	60.4	55.0	54.3	53.3	55.6	58.1	59.4	60.7	62.0
FI	55.1	48.6	47.0	44.6	43.9	42.6	45.3	44.5	44.3
EUR-12 (2)	72.2	74.1	72.8	70.4	69.4	69.2	70.4	70.9	70.9

Note Figures 2000-2003 are based on a revised EDP notification not yet validated by Eurostat; hence, they are to be considered subject to revision. Source: AMECO database.

Source: AMECO database

It would be inappropriate to conclude that the current levels of nominal deficits, against a background of slow growth, poses an immediate threat to the sustainability of public finances in the medium-term. The fact that risk premia on government debt do not appear to have changed despite breaches of the SGP requirements illustrates that markets retain confidence in the capacity of governments to address budgetary problems and to ensure that unsustainable positions will not

[5] Indeed, a general tendency has emerged in several Member States in recent years to base budgetary projections on overly optimistic growth assumptions, which inevitably leads ex post to budgetary targets being repeatedly missed. Such developments in the conduct of fiscal policies are described in European Commission (2001).

[6] The tendency for most EU countries to base budget plans on over-optimistic growth scenarios is documented for instance in Larch and Salto (2003) and Forni and Momigliano (2004).

emerge. However, this apparent confidence of financial markets should not lead to complacency as market sentiment can shift quickly. Given the late and abrupt reaction of financial markets to countries' changed fiscal positions, a risk for the sustainability of public finances in EMU could not be excluded in the future should large underlying budget deficits become the norm in euro-area countries. Hence, consolidation should resume as vigorous as possible, especially as soon as growth prospects appear more favourable, in order to rein in high cyclically-adjusted deficits.

2.2. Did the EMU fiscal framework affect the behaviour of fiscal authorities?

The focus on actual budgetary developments does not specifically address the crucial question on the role played by the EMU fiscal framework in shaping the behaviour of fiscal authorities. Put in another way, to what extent was the avoidance of unsound fiscal policies the result of increased awareness of the benefits of fiscal discipline by Member States and to what extent was this the result of the introduction of the EMU fiscal framework?

Answering the above question empirically focussing just on the 5-year period of EMU is difficult, given the short time frame. However, empirical analysis exists, which covers the period since the introduction of the EU's fiscal framework (i.e. considering also the impact of phase II of EMU). This analysis focuses on understanding whether the reaction of budget balances to the output gap (associated with an output stabilisation motive by fiscal authorities) and debt levels (associated with the purpose of stabilising debt) has changed significantly across Member States since the introduction of the EU fiscal framework.[7] Analyses show in general that after the introduction of the fiscal framework, budget balances became more sensitive to debt levels, i.e., fiscal authorities became more concerned about the need to run low budget deficits.[8] This points to an impact of the EU fiscal framework in affecting the choices of fiscal authorities. Insights of interest on the impact of the SGP on the attitude towards fiscal discipline of European policymakers are also provided by Hughes-Hallet, Lewis and Von Hagen (2004) who investigate empirically the determinants of the probability of running deficits in excess of 3% of GDP in EU countries. Their results indicate that the introduction of the EU framework in 1992 reduced the probability of a breach of the 3% deficit limit with respect to the past. However, they also identify that after 1998 there is an upward trend in such probability, reflecting the stronger disciplinary effect provided by the convergence criteria for the adoption of the euro.

Analysis has also been carried out by the Commission services on this question involving the econometric estimation of counterfactual budget deficits that would have prevailed in the euro area in the absence of the EMU fiscal framework.[9] Such counterfactual budget balances have in turn been used as shocks given to the Commission QUEST macro model, to simulate the economic impact of such an 'absence of fiscal discipline'.[10] In absence of the EMU fiscal framework, the GDP of the

[7] Early analysis on the behaviour of fiscal authorities in EU countries by means of the estimation of fiscal rules is found in Melitz (2002) and Von Hagen, Hughes-Hallet and Strauch (2001). Subsequent work includes Ballabriga and Martinez-Mongay (2002, 2004), Gali and Perotti (2003), European Commission (2004) Turrini and in't Veld (2004) and Forni and Momigliano (2004).

[8] Ballabriga and Martinez-Mongay (2004) analyse systematically the robustness of the debt parameter in estimated fiscal rules with respect to sample split and show that in most Member States the increase in the debt stabilisation objective occurred in the middle of the nineties

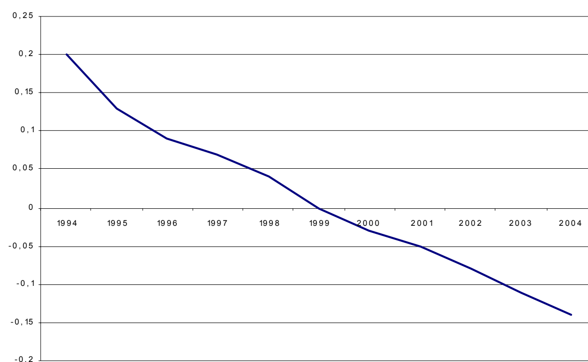
[9] See European Commission (2004).

[10] The estimates show that on average, over the 1994-2004 period, the euro-area primary balance would have been higher by 0.88 GDP points in absence of the EMU fiscal framework (see European Commission (2004)). A description of the Commission QUEST model is contained in Roeger and in't Veld (1997).

euro area would have been higher in the early years of EMU due to higher aggregate demand associated with the implied fiscal expansion. However, such positive impact on output appears rather low and turns negative after some years, due to private investment crowding-out (see Figure 2).[11] This analysis supports the idea that the EMU fiscal framework, by changing the behaviour of fiscal authorities, may have prevented growth in the euro area being even lower compared with actual figures.

A linked question is whether the introduction of the EU fiscal framework led to a less counter-cyclical, or more pro-cyclical, conduct of fiscal policy, as expected by some academics. Here too, analysis only focused on the last five years are not available. Among the most recent and exhaustive analyses there is the one provided in Gali and Perotti (2003). In this analysis fiscal rules (i.e., the behavioural rules that are implicitly followed by fiscal authorities when setting budget balances) are estimated for euro-area countries and it is shown that after 1992 fiscal policy in the euro-area become on average more counter-cyclical, i.e., there was a bigger negative response of the primary cyclically adjusted budget balance to the output gap.[12] This result is consistent with the view that in the pre-EMU period counter-cyclical fiscal policies in Member States were the exception rather than the rule.[13] It is also consistent with the suggestion that under the SGP more attention paid to cyclically-adjusted balances leading to the creation of safety margins would allow for the full working of automatic stabilisers and hence a less pro-cyclical policy than in the past.[14]

Figure 2. Euro-area GDP in absence of fiscal discipline, simulation with the Commission QUEST model (% change of GDP compared with baseline)



Note: simulated GDP in response to an increase in the average euro-area primary budget deficit of 0.88 GDP points over the 1994-210 period.
Source: European Commission, Public Finance in EMU-2004, European Economy, Reports and Studies, 3.

[11] Simulations assuming no impact of increased debt on the risk premia on government bond interet rates show that the fiscal loosening has a small positive initial impact on GDP which shrinks over time, becoming negligible after about 10 years and slightly negative in the long-run. Simulations admitting an impact of increased debt on risk premia show that the effects on GDP of fiscal loosening can become negative already after few years (6 years assuming a 1 basis point increase in risk premia for each additional GDP point of debt; 3 years assuming a 2 basis points in GDP).

[12] However, recent evidence reported in IMF (2004) the response of fiscal authorities of euro area countries before and after the introduction of the euro was quite different, with fiscal policies on average more pro-cyclical after the introduction of the euro.

[13] See, e.g., Buti and Sapir (1998).

[14] See Buti and Giudice (2002).

3. DID THE FISCAL FRAMEWORK EVOLVE EFFECTIVELY TO DEAL WITH EMERGING BUDGETARY CHALLENGES?

As outlined in the introductory section of this paper, the Treaty and Stability and Growth Pact provide the broad framework for the conduct of fiscal policies in EMU. Any assessment of the EU's budgetary framework therefore needs to consider how policy makers implemented the framework and whether they effectively reacted to changing economic conditions and emerging budgetary challenges. Section 3.1 summarises the work undertaken over the last years to improve the design and implementation of the framework for budgetary surveillance, focusing on the definition of an appropriate medium-term budget position for Member States, techniques for adjusting budget balances for the impact of the cycle, and the assessment of long-term developments in public finances. Section 3.2 summarises analyses on key issues related to the conduct of fiscal policy in EMU that featured prominently in the debate over the past few years. Particular attention has been paid to the role of fiscal policy as an adjustment instrument, i.e. whether there are certain circumstances when the active use of discretionary fiscal policies for demand management purposes is warranted, and what is the role and effectiveness of the automatic fiscal stabilisers.

3.1. Efforts to improve the framework for budgetary surveillance

3.1.1. The appropriate medium-term budget objective

One of the major issues in the debate on fiscal policy in EMU has been to clarify the concept of budget positions of "close to balance or in surplus" set down in the SGP. In particular, a debate has taken place as to what in practice constitutes an appropriate medium-term objective.

Calculations made in the early years of EMU suggested that the Member States should build a safety margin of about 2% (i.e., to run cyclically-adjusted budget balances not higher than 1%) to guard against the effect of severe cyclical downturns and the associated risk of breaching the 3% limit.[15]

Subsequently, an additional safety margin, estimated to be in the order of between 0.5% and 1% of GDP, was also deemed necessary to deal with unforeseen budgetary developments, such as unexpected tax shortfalls or spending overruns not due to cyclical fluctuations.[16] All in all, this implied that broadly balanced budgets are adequate objectives for most Member States, but a surplus would be advisable for some others. Adherence to such ambitious medium-term objectives would also lower the stock of government debt over time and thereby reduce interest payments, therefore partially offsetting the pressure on public finances arising from ageing populations.

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[15] More precisely, the Commission made reference to countries reaching so-called 'minimal benchmarks', with the minimal benchmark defined as the cyclically-adjusted deficit that would allow automatic stabilizers to play fully while respecting the 3% limit even in the case of particularly unfavourable, but still possible, cyclical conditions. The minimal benchmark is obtained as the difference between 3% and the 'cyclical safety margin', which is in turn given by the product of the country's budget sensitivity times a value for the output gap that reflects the observed average amplitude and frequency of strongly unfavourable cyclical conditions (see European Commission (2002)). Countries' safety margins so obtained differ, depending in particular upon the sensitivity of the budget, but values resulted around 2% fo0r most countries. The Code adopted in 2001 states that "the Commission may continue using, where relevant, these 'minimal benchmarks' as an additional working instrument, but not as a target per se according to the Stability and Growth Pact." On the issue of the safety margin required to respect the 3% deficit ceiling in the case of severe recessions see also Buti, Franco and Ongena (1997) and Artis and Buti (2000).

[16] See European Commission (2000).

Over time and following protracted discussions, it was agreed in the revised Code of Conduct of 2001 that the assessment of compliance of budgetary positions with the medium-term objective would be done taking into account cyclically adjusted balances, as explained below.

3.1.2. The adjustment path to achieve the medium term budget objective

As regards the timing of budgetary consolidation efforts, concerns have been expressed on how to achieve such close-to-balance or in surplus objectives when starting from high levels of deficits, on account that budgetary consolidation could have a negative effect on output in the short run. Differently form what originally expected, the transition towards such objectives is still unfinished, which makes this issue still relevant given the need for several Member States to reduce large cyclically-adjusted budget deficits. The issue was even more relevant given the slow economic growth experienced in 2002 and 2003. In the standard macroeconomic thinking, budgetary consolidations entail a short run cost in term of lost output, while its effect on the long run may be positive, if the consolidation is achieved without an increase in taxation (or better if it creates room for tax reductions). However, as indicated by recent research aimed at assessing the value of fiscal multipliers in the short-run, such impact is probably rather small.[17] Moreover, research started in the early nineties has pointed to the possibility that, under specific circumstances, fiscal multipliers could turn negative, whereby the reduction in budget deficits may actually expand output even in the short-run, due to agents' improved expectations.[18] These findings appear to be consistent with theories that identify a positive impact on consumer expectations of lower taxes in the future implied by the current budgetary consolidation inducing them to raise their consumption plans, and/or on business expectations of higher profitability enabling them to raise investment. In addition, confidence factors may play a more prominent role in the future in light of large unfunded pension liabilities, and therefore reduce further the costs of credible consolidations.[19]

On the basis of these considerations, the European Commission[20] proposed already in September 2002 a 'rule of thumb' for pursuing the budgetary consolidation. It indicated that countries which have not reached the (cyclically-adjusted) 'close to balance or in surplus' objective should be required to undertake every year a minimum adjustment of 0.5% of GDP of their cyclically-adjusted deficit. Such amount was perceived to be sufficiently small to avoid any serious demand effect on economic activity, but at the same time sufficiently large to ensure that repeated over a few years the consolidation towards the medium-term objective would be completed. The Eurogroup meeting of October 2002 produced *Terms of references on the budgetary developments in the euro area* very close to the approach of the Commission, and concurred that those countries which have not yet reached the medium-term objective need to pursue continuos adjustment of the underlying balance by at least

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[17] Evidence for OECD countries using the estimate of structural VAR models is reported in Blanchard and Perotti (2002) and Perotti (2004). According to estimates by Perotti (2004), the cumulated, cyclically-adjusted fiscal multiplier of public spending after 2 years is below 0.5 in all countries investigated (US, Germany, UK, Canada, Australia), meaning that a 1% GDP increase in public spending cut reduces GDP by less than half a point after 2 years. Moreover, spending multipliers turns out to be negative in the UK and Canada. Estimates of the impact of fiscal policy obtained from most applied calibrated macro models also indicate values for fiscal multipliers smaller than those predicted by standard Keynesian models. For a survey of econometric evidence and model-based estimates of fiscal policy effectiveness see, e.g., Hemming, Kell, and Mahfouz (2002).

[18] See, e.g., Giavazzi and Pagano (1990,), Gavazzi, Jappelli and Pagano (2000) and Alesina et al. (2002). Empirical analysis of the experiences of EU Member States (European Commission (2003), Giudice, Turrini, and in't Veld (2004)) shows that roughly half of the episodes of fiscal consolidation undertaken in the past three decades have been accompanied by an acceleration in economic growth.

[19] Consistently, simulations using the Commission QUEST model confirm that budgetary consolidation based on expenditure cuts that reduce permanently deficits and debt may raise output and employment in the medium-term both via increased consumption and investment demand. See European Commission (2003).

[20] European Commission, SEC(2003) 1009/6 of 25 September 2002.

0.5% of GDP per year. Similar wording has been used in the BEPGs adopted in Spring 2003. In practice, however, a number of Member States have not complied with such guidelines, and in fact even let their budgetary position deteriorate which led to both cyclically-adjusted and actual deficit well above 3%, prompting the start of the excessive deficit procedure. By contrast, several countries did follow the guideline by the Commission and the Eurogroup in the conduct of their policies which implied that they actually completed the transition to the close-to-balance or in surplus objective over the last few years.

3.1.3. Taking account of the economic cycle

One the most heavily criticised features of the EU's fiscal framework was the fact that the budget figures (and in particular the reference value for deficits) underpinning EU surveillance are based on nominal budget aggregates. As such, they do not take account of the impact of economic conditions on budget balances. While the reference values remain nominal, however, considerable progress has been made since 1999 to at least introduce the impact of the economic cycle into the assessment of the budget position of Member States and in the definition of policy recommendations, and this on the basis of comparable indicators across Member States on the output gap and cyclically-adjusted budget deficits developed over the last years.

Setting the right targets, and assessing them properly, is an important issue as Member States are called to consistently respect the 3% of GDP reference value while letting automatic stabilisers work freely to smooth the business cycle. An important innovation was made in 2001, when the revised Code of Conduct clarified the role which cyclically-adjusted budget balances are to play when assessing whether Member States meet the budgetary targets set down in stability and convergence programmes. In particular, whilst these targets are established in nominal terms, the achievement of the 'close to balance or in surplus' objective of the SGP is to be assessed over the economic cycle. The Code therefore suggested that the assessment concerning the medium-term target should identify the cyclically-adjusted positions implied by the nominal targets, by taking account of the economic assumptions established in the plans. These clarifications helped to improve the assessment of Member States' budgetary positions under the SGP. Since then, the Council Opinions on the updated programmes explicitly mentioned cyclically-adjusted budget balances.

Although there is a broad consensus in academic and policy circles on the importance of considering cyclically-adjusted budgetary positions when reaching policy conclusions, opinions diverge on how in practice they should be calculated. In an ideal world with sufficient information on all budgetary developments and policy measures, it would be possible to adjust each budget item directly to reflect their 'true' cyclically-adjusted position. However, information of such quality is usually not available. Consequently, indirect methods are used whereby the cyclical budgetary component is inferred from the co-variation of government revenues and expenditures with output fluctuations.[21]

However, this approach implies that output fluctuations around its potential need to be identified carefully. Accordingly, among the measurement issues on which the debate has focused, there is almost naturally the one concerning which approach to use for estimating potential output and output gaps. Until 2001, the Commission has used a statistical approach to estimate trend GDP and the output gap (the so-called Hodrick-Prescott (HP) filter). Given the limitations of the HP method, Member States and the Commission agreed to move to an estimation method more grounded in

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[21] The CAB is computed as the actual budget balance (B) adjusted by the cyclical budget component. The latter is estimated as the GDP output gap (G), i.e., the percentage difference between actual and potential output, times the budget sensitivity to the output gap (α). Hence, $CAB = B - \alpha * G$. The values of the budget sensitivities used by the Commission are based on budget elasticities (i.e., the percentage change in budget items associated with a percentage change in GDP) estimated by the OECD (see Van den Noord (2000)).

economic theory. [22] The new method for computing potential output, based on the estimations of aggregate, country-level, production functions was endorsed by the ECOFIN Council of 6 November 2001 and constitutes now the reference method in Commission forecast and when assessing stability and convergence programmes.

3.1.4. The sustainability of public finances

Since the start of EMU, there has been an increasing focus on longer-term budgetary profiles, in order to prepare in advance for ageing population. The European Council in Stockholm (March 2001) agreed that "…the Council should regularly review the long-term sustainability of public finances, including the expected strains caused by the demographic changes ahead".

Together with the national authorities in the Economic Policy Committee, the Commission has worked to produce comparable, long-run budgetary projections covering public spending on pensions, health care, long-term care, education and unemployment transfers. Table 3 summarises the latest available long-term budgetary projections for age-related expenditures. In a 'no-policy change scenario', age-related expenditure is projected to increase by more than 4 percentage points of GDP in at least 9 out of 15 countries by 2050.[23]

Table 3. Age-related expenditure long term trends in EU-15 countries (% GDP).

		Age-related expenditure								
		Pensions		Health care		Education		Others		Total change
	Source	2008	2050	2008	2050	2008	2050	2008	2050	
BE	2003 update	8,8	12,6	7,1	9,9	4,1	3,7	6,7	5	4,5
DK	2003 update	5,5	6,9	8	10,4	8,7	8,4	9,3	11,2	5,4
DE	2003 update	11	14,9	5,9	7,1	5,3	5,5	0,9	0,7	5,1
EL	2002 update/EPC	12,3	22,6	5,1	6,6	3,3	3,2	0,4	0,2	11,5
ES	2003 update/EPC	8	13	5,7	7,2	4	3,7	0,6	0,4	6
FR	2002/2003 updates	12,7	14,5	6,4	7,4	5,9	5,5	1	0,7	2,1
IE	EPC	4	7,7	6,1	7,8	4	3,2	1	1	4,6
IT	2003 update	14	14,1	6,4	8,1	4,6	4,2	0,4	0,3	1,3
LU	2002 update/EPC	7,4	9,3	n.a.	n.a.	n.a.	n.a.	0,3	0,2	1,8
NL	2003 update	5,2	8,7	7,5	10,5	5	4,9	6,6	6,9	6,7
AT	2003 update	14,6	15	5,2	6,4	5,6	5	1,5	2	1,5
PT	2003 update/EPC	11,3	12,1	5,3	6,1	5,4	5,1	0,5	0,5	1,3
FI	2003 update	11,6	14,5	4,8	5,8	5,8	5,4	3,3	4,8	5
SE	2003 update	9	9,9	11	13,4	8,2	8,7	6,8	9,7	6,7
UK	2003 update	5,1	5,3	7,7	9,7	5,4	5,4	1,4	1,5	2,3

Source: European Commission, Public Finances in EMU - 2004.

Source: European Commission, Public Finances in EMU - 2004

In addition to making common projections, progress has also been made in systematically incorporating issues related to sustainability into the budgetary surveillance process. Since 2001, the Commission monitors long-term budgetary trends in the context of the Stability and Growth Pact, by including an assessment of the long-term sustainability of public finances as part of the overall

[22] See European Commission (2000), "Public Finances in EMU – 2000", European Economy, Reports and Studies, n°3.

[23] See European Commission (2003) and EPC (2003).

assessment of the stability and convergence programmes. The assessment is based on both a quantitative and qualitative analysis.

Concerning the quantitative part of the assessment, debt developments are extrapolated up to 2050 on the basis of the latest available estimates of age-related expenditures and the agreed macroeconomic assumptions on nominal interest rates, real growth and inflation (see EPC, 2003). Concerning the remaining fiscal variables of countries, two alternative scenarios are considered. Under a so-called "programme" scenario, the starting position in terms of the cyclically-adjusted budget balance, the level of the debt to GDP ratio, the primary spending and the tax revenues are the figures reported by the Member State for the final year of their latest updated stability or convergence programme. The "programme" scenario assumes that Member States actually achieve the budget targets set down in their programmes. However, since such an outcome is not assured, an alternative scenario (called this year "2003 position" scenario) is considered in which debt levels are extrapolated assuming that the cyclically adjusted primary balance remains at the same level of the latest fiscal year. [24]

Table 4 – Long term debt to GDP ratio in EU-15 countries.

	2003	Programme scenario			2003 budget scenario		
		2010	2030	2050	2010	2030	2050
BE	102.3	74.8	11.5	-5.0	67.2	-35.7	-114.0
DK	42.7	24.6	-19.5	-34.8	6.9	-65.5	-131.9
DE	64.0	62.2	86.5	175.7	74.3	156.5	336.6
EL	101.7	75.1	42.2	151.0	72.2	52.4	181.0
ES	51.8	36.3	-1.6	36.6	31.6	-21.4	-12.4
FR	61.4	56.0	52.2	72.0	71.8	142.1	288.0
IE	33.1	26.7	36.4	105.0	27.0	50.1	138.4
IT	106.0	86.6	28.9	-27.8	92.0	82.7	107.8
LU	4.9	-0.9	-9.4	1.2	-3.9	-35.7	-47.8
NL	54.0	49.1	67.6	140.0	53.8	88.7	185.9
AT	66.4	53.9	24.4	15.9	55.1	26.1	18.4
PT	59.5	48.0	5.3	-42.4	60.9	72.1	127.6
FI*	-14.6	-33.4	-30.1	6.0	-52.8	-79.5	-88.6
SE*	33.0	16.4	-0.4	46.7	15.2	19.8	97.6
UK	39.3	42.5	71.6	138.7	45.3	89.5	177.5

* Adjusted gross debt, netting off the accumulated liquid financial assets.
Source: elaborations by the Commission services

Table 4 summarises the main results of the analysis for long term sustainability of public finances (S1 indicator). The emerging U-shape of the debt to GDP ratio in most countries under the "programme" scenario proves that there is a window of opportunity during the next years to run

[24] In the absence of an agreed definition of public finances' sustainability, two alternative criteria have been used by the Commission services in assessing the long-term sustainability of the public finances of EU Member States. A first measure (S1) measures the difference between the current tax ratio and the tax ratio that would ensure a debt level in 2050 as resulting from a balance budget position over the projection period. A positive sustainability gap indicates that higher taxes are needed to reach this debt level in 2050. A second measure (S2) indicates the change needed in tax revenues as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon. Since the round of assessment concluded in Spring 2004, the operational specification of the S1 indicator is undertaking a refinement, in order to be built on the assumption that the debt-to-GDP ratio ensures a specific debt value at the end of the projection period.

down the debt-to-GDP ratio. In the coming twenty or twenty-five years, debt levels are projected to decrease due to the effect of maintaining balanced budget positions: however, this trend would start to reverse once the budgetary impact of ageing starts to take hold, with the largest increase in most countries expected between 2030 and 2050. The risk of unsustainable public finances increases considerably if the Member States do not achieve the SGP goal of budget positions of 'close to balance or in surplus'. An indication of this can be seen by comparing the projected debt levels under the "programme scenario" with the "2003 budgetary position" scenario.

Qualitative information on the policy environment characterizing different Member States complements the information arising from the quantitative indicators. Current debt levels, assets accumulated by the public sector, stock-flow operations, one-off budgetary measures, reliance on a high tax burden, and the overall robustness of the projections are all elements which play a relevant part in the assessment by the Commission and the Council on sustainability of the public finances of the Member States.

Further improvements in the assessment of sustainability are currently discussed at EU level. These could include a better link between the quantitative and quantitative analysis, a new set of health expenditure projections, the inclusion in the quantitative analysis of some kinds of assets, improved information about the implications of structural reforms, and a calculation of indicators based on assumptions regarding a end-of-period debt level.

3.2. The debate on the conduct of fiscal policy in EMU

3.2.1. Active use of fiscal policy

In spite of the well-known limits of discretionary policy, some observers called for a more active use of fiscal policy in the monetary union: their argument was that having lost control over monetary policy and the nominal exchange rate, governments may need to take action to correct country-specific macroeconomic imbalances. In the same direction, it could also be argued that fiscal policy at national level may be more efficient in the EMU framework than in the past, thanks to lower crowding-out effects and the disappearance of risk premia linked to possible currency depreciation. Finally, better stabilisation at national level - by limiting inflationary or deflationary pressures - could have positive spillover effects at EMU level by facilitating the task of the ECB of guaranteeing price stability, as euro-area inflation would be less volatile. Everything else being equal, the advocates of a more active use of fiscal policy in EMU to compensate for the loss of monetary and exchange rates autonomy had a few arguments.

However, even within a basic Keynesian framework, a number of arguments point towards avoiding an active use of fiscal policy.[25] First, political economy and institutional constraints tend to limit considerably the scope for active fiscal management. In particular, discretionary fiscal management has a major pitfall related to implementation lags, which may cause that counter-cyclical measures can easily turn out to be pro-cyclical as policymakers do not have perfect foresight of future (and even ongoing) economic developments. Second, trade in the single currency area – and related spillovers – will increase, thereby possibly reducing the effectiveness of domestic fiscal policy. Third, the possibility of free-riding at national level, reflecting a muted reaction of the common monetary policy to national developments, may induce an excessive use of discretionary loosening (expansionary bias), with a resulting pro-deficit bias. Finally, given the number of countries involved, inappropriate fiscal policies, if carried out simultaneously, may increase the uncertainty as to the

[25] See, for instance, Auerbach (2002) for a recent assessment of the effectiveness of discretionary fiscal policy. See also Buti and Van den Noord (2003) for evidence analysing the relation between elections and discretionary fiscal policy action in EU countries. For a thorough analysis of this issue, see European Commission (2001 and 2002).

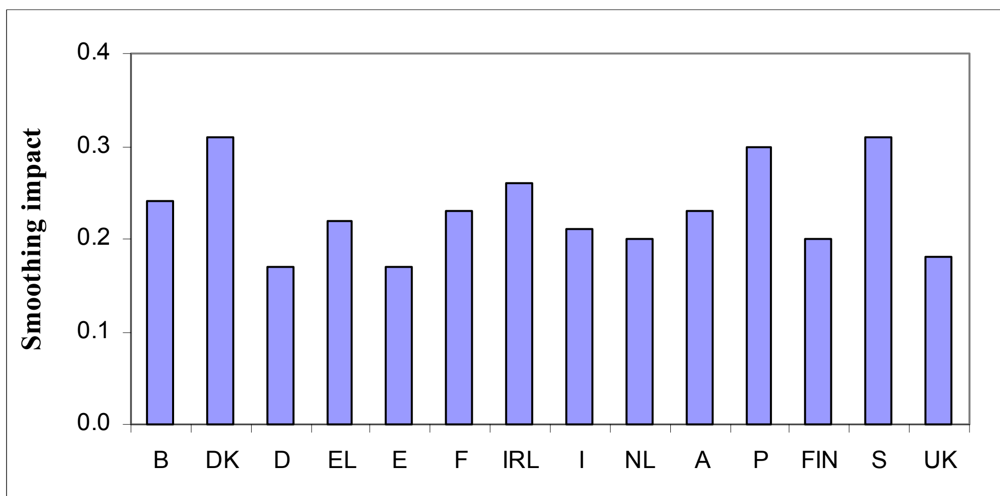
overall effect and the spillovers throughout the euro area, including on price developments and could therefore trigger countervailing action by the ECB. As reported in section 3.1.2, recent empirical research aimed at assessing the impact of fiscal policy on output shows that the value of fiscal multipliers is rather low in most advanced economies and that it has been falling.

The results of this analysis confirm the sceptical approach to discretionary policy, given the conclusion that counter-cyclical fiscal policy which supplements the operation of the automatic stabilisers ought be restricted to the case of large, country-specific and domestically-driven demand shocks. Nevertheless, the difficulty in identifying the nature of the economic shocks and putting in place an adequate fiscal package considerably limit the scope for active fiscal policy.

3.2.2. The effectiveness of automatic stabilisation

While discretionary policy should be used in very limited cases and with caution, the question remains about whether automatic stabilisers are always helpful in stabilising the economy and whether they are on their own sufficient in the face of strong asymmetric shocks. The effect of automatic stabilisers largely depends on the type of shocks hitting the economy.[26] In the event of demand shocks, such as an acceleration of private consumption or a sudden fall in exports, automatic fiscal stabilisers can play a useful role as they cushion the impact both on output and prices, which move in the same direction after the shock.

Figure 3 . Stabilisation effect provided by the budget in response to a consumption shock amounting to 1% of GDP (simulations with the Commission QUEST model)



Source: European Commission, Public Finance in EMU-2002, European Economy, Reports and Studies, 3.

In contrast, supply shocks typically affect output and inflation in opposite directions: for example, with a positive productivity shock there is at the same higher output and lower inflation. If the supply side shock is only a temporary phenomenon, automatic stabilisers do smoothen output, but at the cost of higher inflation. However, if the supply-side shock is permanent (i.e. it affects the level of

[26] A formal treatment of the effects of automatic stabilisers on output and inflation under different types of shocks is presented in European Commission (2001). For evidence on the effectiveness of automatic stabilisers in OECD countries see Van den Noord (2000).

potential activity), automatic stabilisers may delay the necessary adjustment towards the 'new' level of potential output. The empirical evidence shows that automatic stabilisers are quite effective in the case of shocks to private consumption, whilst they are less effective in the case of shocks to investment or external demand. Figure 3 reports estimates of the smoothing impact of automatic stabilisers obtained via simulations with the Commission QUEST model in case of a consumption shock.

4. WAS THE EXPERIENCE WITH THE APPLICATION OF THE FISCAL RULES OF EMU SATISFACTORY?

4.2. Experiences with the enforcement of the framework

The EU fiscal framework foresees several mechanisms for exerting peers pressure on countries to achieve and maintain fiscal discipline, and includes enforcement mechanisms in the event of countries approaching or breaching the reference values for deficits and debt. Should significant slippage from the targets set in the programmes be identified, the Council can issue an "early warning", i.e. a recommendation urging the Member State concerned to take adjustment measures. If deficit levels go above the 3% of GDP reference value (and unless there are exceptional circumstances to justify such an occurrence), a country is placed in an excessive deficit position. The SGP clarifies a tight timetable for the application of Excessive Deficit Procedure, and also spells out the type and scale of sanctions that can be applied in the event of persistent failure to take corrective measures.[27] So far the implementation of the Pact has never arrived at the sanctions stage.

In February 2002, early warnings were prepared by the Commission to be addressed to Germany and Portugal. However, they were not adopted by the Council. The latter accepted the commitments taken by these countries to avoid breaching the deficit ceiling. In fact, in spite of the policy action taken by the government of the two countries, deficits in both countries quickly rose above 3% of GDP, which led to the start of the procedure for prompting the correction of the excessive deficit between the end of 2002 and early 2003. The early warning was adopted in the case of France in January 2003, but the budgetary situation of this country deteriorated very rapidly, with the consequence of France being placed in an excessive deficit in mid-2003. These events show that the preventive procedure was not used at the appropriate time, as deficits were already too close to 3% of GDP.[28] Having deficits above 3% of GDP already since 2002, both Germany and France had been recommended to bring them below 3% of GDP by 2004 at the latest. In November 2003, when it became evident that both France and Germany would have not been able to do so, the Commission prepared new recommendations to take effective measures to correct the deficit addressed to these two countries by 2005, while increasing the surveillance and advancing with the

[27] In the first year of application of the sanctions, the country in question is required to make a non-interest bearing deposit composed of a fixed component equal to 0.2% of GDP and a variable component equal to one tenth of the difference between the deficit and the 3% of GDP reference value. A ceiling of 0.5% of GDP is set. The fixed component aims at providing an incentive not to incur an excessive deficit, while the variable component represents an incentive to limit the excess over the 3% of GDP threshold. In each subsequent year, until the excessive deficit decision is abrogated, only the variable component will be applied. As a rule, a deposit is to be converted into a fine after two years if the excessive deficit persists.

[28] For documents concerning these procedures, see the section on Fiscal Surveillance on the website of the DG ECFIN: http://europa.eu.int/comm/economy_finance/about/activities/sgp/procedures_en.htm. See also Part II of the 2003 and 2004 reports "Public Finances in EMU", European Commission (2003 and 2004).

procedure. However, the Council did not endorse the steps taken by the Commission, and de-facto suspended the excessive deficit procedure.[29]

Subsequently, new excessive deficit procedures have been launched concerning Greece and the Netherlands, while the one concerning Portugal has been abrogated. Given the temporary excess of the deficit on the reference value, it was considered not necessary to start a procedure regarding the UK. The Commission also tabled a recommendation for the Council to send an early warning to Italy, given its forecast for 2004. Following commitments by the Italian Prime Minister, intervened at the ECOFIN Council, the latter however did not adopt the recommendation. In July 2004, following their accession, the Council also placed six new Member States into an excessive deficit position.

4.2. Overall experience with the functioning of the framework

Five years since the birth of our single currency and the entry into force of the Stability and Growth Pact (SGP), we can make an overall positive assessment on the functioning of Economic and Monetary Union. In spite of recent difficulties, there has been no return to the profligate budget policies of the past. The Stability and Growth Pact and multilateral surveillance have played a decisive, albeit sometimes difficult, role in containing the deficit levels during the economic slowdown. Overall the public finances situation seems more sustainable than five years ago in most EU countries , which is an important condition for a strong and long-lasting economic performance of the Union.

However, while the overall judgement is positive, it is fair to say that there was also a fair share of problems. The application of the framework can be improved, to deal with some weaknesses in its implementation or, possible, in its design. Among the areas where improvement seems needed, we would mention the following: [30]

Firstly, the EU coordination framework has been perceived as focusing mainly on fiscal policy, and in particular on budgetary balances and fiscal discipline, rather than on the overall interaction of various policies. This has however been changed de facto with the emergence of the Lisbon agenda, which stress the importance of consistency between various economic policy objectives. In this context, fiscal discipline must be seen together with the quality of public finances. It is therefore clear that efforts need to be made to better interlink economic and budgetary policies. In our view this requires an "upgrading" of the Broad Economic Policy Guidelines (BEPGs) as the instrument of choice for the coordination of economic policies and a better coordination of the BEPGs with the budgetary coordination carried out through the Stability and Growth Pact (SGP).

Second, the rules which apply to budgetary policy coordination have on some occasions shown their shortcomings, in particular as they do not provide adequate incentives for prudent behaviour during the good times of the economic cycle and dot not take sufficiently into account the changing economic and budgetary circumstances within the EU. In addition, the rules determining the various steps in the excessive deficit procedures of the Treaty have proven to be quite rigid and complex, not always well defined, and sometimes difficult to comply with, in particular when they relate to compliance with the recommendations.

It is true that the Commission has over the last few years improved the implementation of the Pact by applying economic rationale to the interpretation of its rules, and to a large extent it has been

[29] The Council also adopted 'conclusions' which attempted at changing the content of the previous recommendations addressed to the two countries. The Commission brought the issue before the European Court of Justice, which annulled the conclusions with its ruling of 13.7.2004.

[30] For a review of problems and challenges concerning the SGP see also Buti and Giudice (2002) and Giudice and Montanino (2003).

followed by the Council. However it seems evident that this approach cannot be pushed any further unilaterally by the Commission without losing credibility and without putting the rules-based system at risk. There is a need therefore to strengthen the implementation and improve the interpretation of the Stability and Growth Pact together with the member states through a credible process, in order to create political consensus around an improved implementation, a consensus able to outlive the test of time.

Thirdly, the enforcement by the member states of the provisions concerning both the prevention and the correction of unsound policies has not always been sufficiently reliable. The political ownership of the SGP by Member States has diminished with a divergence between budgetary commitments and concrete actions to achieve stated targets, and unwillingness to acknowledge the implication of EMU on the conduct of fiscal policy at national level. More generally, Member States failed to play their role in exerting peer pressure on countries that miss budgetary targets by a wide margin via the enforcement mechanisms of the SGP. Thus, the implementation of the fiscal framework has not been always consistent with the ambition of the Treaty and the Stability and Growth Pact. To a certain extent, this has led to a loss of credibility and ownership and even to institutional uncertainty at the European level.

4.3. Efforts to improve the framework for fiscal policy in the early years of EMU

During the first 5 years of operation of EMU there were several instances in which the statements and actions of Member States have underlined the lack of a coherent medium-term orientation for the conduct of fiscal policies in a monetary union. A main reason for this could have been the lack of consensus on key issues in the economic profession, e.g. the appropriate measure to identify sustainable public finance positions or the impact of discretionary fiscal measures on the domestic economy and that of other euro area Member States. It was recognised that there was scope to improve the framework for fiscal policy in the EU in several respects. Consistently, a series of efforts were made in the early years of EMU to improve the framework for fiscal policy.

In ***February 2001***, the Commission adopted a Communication to clarify the three main elements on which economic policy co-ordination should be based: a common assessment of the economic situation; agreement on appropriate economic policy responses; acceptance of peer pressure and, where necessary, adjustment of policies. [31] The Communication led to several positive developments including: better and more timely statistics covering the euro area; a quarterly report on the euro area prepared by the Commission; the establishment of a Eurogroup working party attached to the Economic and Financial Committee (EFC) to help prepare debates; and regular communiqués (so-called Terms of Reference) from the Eurogroup on important policy issues.

The Barcelona European Council of ***March 2002*** concluded that the euro area needed to make further progress with policy co-ordination and invited the Commission to present proposals to reinforce economic policy co-ordination in time for the 2003 Spring European Council. The initial response of the Commission to this mandate was to suggest that all euro-area countries adhere to common standards for the conduct of economic policies in the euro area. [32]

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[31] Commission Communication on "Strengthening economic policy coordination within the euro area", COM(2001) 82 final of 7.2.2001.

[32] The objective of common standards would be to clarify the respective role of economic policies in three domains - (1) preserving macroeconomic stability, (2) enhancing the economic growth potential of the euro area and (3) responding to economic shocks that affect individual Member states or the euro area as a whole. Concerning their format and status, the intention was for common standards to complement the existing Treaty provisions and Stability and Growth Pact regulations with non-binding guidelines on the policy stance expected of authorities in various

The discussions on common standards, however, became overshadowed by the deterioration in budget balances and the difficulties in implementing the Stability and Growth Pact. In ***November 2002***, the Commission adopted a Communication to strengthen coordination in the field of budgetary policy. This Communication focused on potential improvements that could be made to the implementation of the SGP and did not deal with wider issues related to the conduct of fiscal policy in EMU which had been considered in the debate on common standards.[33] *Inter alia,* the Communication argued in favour of more account to be taken of underlying economic conditions when assessing budgetary positions, an interpretation of compliance with SGP requirements that would (depending on country specific circumstances) cater for the budgetary impact of reforms that enhance growth and employment, increasing the emphasis placed on the sustainability of public finances and outstanding debt positions, and improving the implementation of the SGP including stricter and more timely recourse to the existing enforcement instruments. At the same time the Commission adopted proposals to improve the governance of budgetary statistics. The Spring European Council of March 2003, endorsed a report of the (ECOFIN) Council which shared many of the Commission's proposals on strengthening the co-ordination of budgetary policies.

5. WHAT FUTURE AFTER FIVE YEARS OF EXPERIENCE ?

On the basis of the experience of the first five years of EMU, and following earlier attempts to improve the framework, the Commission made in September 2004 new suggestions on how economic governance could be strengthened.[34] Recalling the effectiveness of the main element of the framework, however, it stressed that the two nominal anchors of the Treaty – the 3% reference value for the deficit to GDP ratio and the 60% for the debt to GDP ratio – have proven their value and will continue to remain at the centre of multilateral fiscal surveillance. In our view, and consistently with the approach suggested by the Commission, improvements should go in the following direction.

The first step to move to a strengthened framework would be to ***increase the focus on debt and sustainability*** in the surveillance of budgetary position. This would strengthen the rationale of the framework. The EU framework has various elements already related to debt and sustainability, aiming respectively at avoiding substantial policy errors (debt criterion); ensuring prudent budgetary policy by providing policy objectives which should be pursued in the medium term (medium-term objective); and giving policy assessment and therefore providing guidance on the basis of long-term trends. Increasing the focus on debt and sustainability implies that more attention should be paid to the medium-to-long-term budgetary impact of current policies. At the same time, more consideration should be given to expected future (budgetary) trends both when current budget policies are decided and when surveillance is made. In principle, compliance with the deficit ceiling should implicitly ensure adequate debt reduction and sustainability of budgetary positions. However, in several countries there has been a weakening link between the budgetary balances and debt dynamics. Indeed, compliance with the deficit ceiling has at times entailed short-sightedness in the conduct of budgetary policies, including the recourse to one-off measures. Increased focus on debt dynamics,

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circumstances, i.e. a so-called 'reaction function'. The aim was to facilitate discussions amongst Ministers on policy challenges as they emerged, and thereby contribute to a more consistent policy stance over time and across Member states.

[33] Communication on "strengthening the co-ordination of budgetary policies", November 2002. This followed a statement issued on 24 September 2002 by Commissioner Solbes, with the agreement of President Prodi, SEC(2003)1009/6 of 25 September 2002.

[34] Communication on "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact", COM(2004)581 , of 3 September 2004.

including through more active surveillance of the respect of the debt criterion of the Treaty, would complement continued rigorous attention to deficit developments and should contribute to achieving prudent debt positions over the long term. Also the assessment of long-term trends has a relevant role in the surveillance of budgetary polcieis.

Second, the ***definition of the medium-term objective***, a key element of prevention, also would ***need to be revisited*** along these lines, in particular to take into account debt, sustainability and economic circumstances. Given the increasing economic diversification in a Union of 25 Member States, a uniform specification of the medium-term objective for all countries does no longer appear adequate. Revisiting the definition of the medium term objective would imply that objectives could differ across countries. Those countries which need to improve the sustainability of public finances need to maintain budget positions close to balance or in surplus for a sustained period, until progress is made on reducing debt levels and, if necessary, implicit liabilities. For countries where current positions and expected economic and budgetary developments imply that sustainability is secured for the future, small deficits could be allowed without jeopardising such prospects. This approach provides a "proxy" to the economic rationale of the so called "golden rule" mentioned so often in the debate. But it does not entail all its risks, such as accounting problems arising from the definition of which expenditure should be classified as investment, the drift towards high deficits if a large part of the budget is excluded from the surveillance, and the bias towards physical capital which the "golden rule" could induce at the detriment of other forms of productive expenditure. It needs to be stressed, however, that such approach towards defining the medium term objective should ensure compliance with the 3% reference value under normal circumstances and guarantee equal treatment across Member States.

The third element more directly linked to the implementation of the SGP would be to ***strengthen enforcement***. This calls for an improved preventive mechanism. Experience has highlighted the need to conduct prudent and symmetric over-the-cycle policies to avoid running into troubles at a later stage. Incentives to run such policies should be strengthened. Reinforcing peer pressure, possibly by a more active use of early warnings, is an important option to ensure the appropriate policy action during the good times. It seems evident that all efforts should be made to make peer pressure work, as ultimately is the instrument on which the Treaty mainly relies. Clearly, more public debate on budgetary surveillance could also improve the enforcement mechanisms. In this context, greater involvement of national bodies monitoring national budgetary and economic policies and publication of their views in public should be encouraged. In addition, a closer involvement of national parliaments in the co-ordination process could help to bolster accountability at the Member State level and increase the effectiveness of peer pressure. At the same time, prevention and peer pressure rely on clear and reliable information. Shortcomings in the collection of national statistics in some Member States identified over the last five years, and most recently put in evidence by the revision of the Greek data, must also be addressed. It is of the utmost importance to ensure minimum European standards for the institutional set-up of statistical authorities and tougher surveillance mechanisms by Eurostat in this domain should be accepted. Efficient budgetary and economic surveillance is impossible without reliable statistics.

The ideas indicated above related to the preventive part of the SGP seem to benefit from a large consensus, both in the academic and political spheres. As an example, the Informal ECOFIN meeting of 10-11 September, in its statement on the SGP, supports them explicitly: 'In strengthening and clarifying the Stability and Growth Pact, due consideration should be given to strengthening its economic rationale and implementation. […] The preventive arm of the Pact should be strengthened. […] The focus on debt and sustainability should be enhanced.'[35]

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[35] Statement by the ministers of Economy and Finance on "the Stability and Growth Pact", 10-09-2004, available at http://www.eu2004.nl

Concerning suggestions on how to improve the implementation of the corrective measures, that is on how to ***improve the implementation of the excessive deficit procedure***, an essential point to note is that if the ideas presented above are actually implemented and the preventive action works satisfactorily, it should be much less frequent to see Member States with excessive deficits in the future. If countries would respect their medium-term objectives in cyclically-adjusted terms, it is very likely that countries would only breach the reference value of the Treaty only as a result of ***exceptional and temporary circumstances***. In these exceptional cases, the Treaty itself foresees that the country should not be placed in an excessive deficit positions, and should not be required to take corrective action. While the SGP spells out which situations could be considered exceptional, it does not properly include among them the case of protracted slowdowns. In order to increase the correspondence of the rules with economic reality, this could be corrected. However, such economic circumstances could also be considered in another but closely related part of the procedure: the timing for the correction of the excessive deficit. For countries in excessive deficit, prompt and firm corrective action would continue to be necessary. Nevertheless, such action should not be taken at any cost. Accordingly, it could be worth revisiting the provisions of the SGP specifying the ***adjustment path for the correction of an excessive deficit*** in order to consider cyclical conditions faced by the country and risks to sustainability. The principle would remain that an excessive deficit should be corrected promptly, but the influence of economic developments outside the control of the government on the budgetary outcome could be taken into account. The Commission has already taken steps to this end, for example by considering economic developments in its recommendations for the correction of excessive deficit concerning a number of countries in EDP in the past. However, the framework would benefit from becoming more transparent on this aspect. Clearly, a balance would need to be maintained between making changes in the direction indicated here and the need to have rules which ensure sufficient deterrence and are enforceable.

Finally, we should mention the last element of the Commission suggestions: ***budgetary policies should better contribute to*** progress towards achieving the economic objectives set in the ***Lisbon strategy***. This can be achieved by improving the quality of budgets on the expenditure and the revenue side. For this purpose, the link between the Broad Economic Policy Guidelines and the Stability and Growth Pact should be reinforced. In practical terms, a more efficient contribution of the EU to the conduct of national policies could be achieved by bringing the EU budgetary policy co-ordination calendar more into line with the general economic policy co-ordination cycle.[36] This would mainly imply advancing the submission and assessment of the Stability and Convergence Programmes, which would become a strategic ex-ante exercise earlier in the year. As a result, the content of the Broad Economic Policy guidelines and the Opinions on the Programmes could be better taken into account in the preparation of national budgets in the second part of the year. The suggested creation of the European and national semesters for economic policy would strengthen the link between the submission and assessment of the stability and convergence programmes and the Broad Economic Policy Guidelines, while at the same time increase their effects on national budgetary procedures. It would allow budgetary policy to be placed in a broader context through a comprehensive analysis of policy choices and of their contribution to the overall objective of enhancing the Member States' growth potential.

6. CONCLUSIONS

In this paper we have highlighted the main elements of the experience with the EMU framework in its first five years of functioning. The EMU framework has contributed to avoid large fiscal imbalances in EU Member States and has evolved continuously to deal with a number of budgetary

[36] See Fischer and Giudice (2001) for considerations about the relative role of Stability and Convergence Programmes and the BEPGs, and Sapir et al. (2003) for earlier ideas about moving to an EU semester.

challenges connected to the conduct of fiscal policy and the assessment of budgetary developments in the short, medium and long run.

If in the first five years of EMU our economic governance framework did a good job in contributing to the establishment of macroeconomic stability, the experience tells us that further improvements are needed to ensure the sustainability of public finances, increase their contribution to growth and reflect the growing economic diversity in the Union. We have identified a number of objectives to be pursued in order to improve the economic and budgetary co-ordination framework of the EU. We believe that reinforcing the link between the EU rules and economic reality, by increasing the standing and effectiveness of this framework, would go in the right direction. Some rebalancing between automatism and discretion appears also needed, in particular to reduce the degree of discretion currently existing in some parts of the framework and at the same time to increase the degree of realism of some 'automatic' provisions which proved too restrictive.

The window of opportunity to make these improvements which is open in front of us should not be wasted. We consider that some of our suggestions could be usefully taken into account to strengthen the EU framework for economic governance.

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