Chapter 17

Fiscal policy and the Stability Pact

Over the last months, Europe has gone through a serious financial crisis. Although economic recovery in Europe is now on track, risks remain and we must continue our determined action. We adopted today a comprehensive package of measures which should allow us to turn the corner of the financial crisis and continue our path towards sustainable growth.

Conclusions of European Council of March 24–25, 2011

I know very well that the Stability Pact is stupid, like all decisions which are rigid.

Romano Prodi (EU Commission President), *Le Monde,* 17 October 2002

Chapter Contents

Introduction

With the loss of monetary policy as a macroeconomic stabilization instrument, fiscal policy may assume greater importance in a monetary union. However, national fiscal policies affect other countries in a number of different ways. Do these spillover effects also call for sharing the fiscal policy instrument? This chapter first reviews how fiscal policy operates across national boundaries and presents the principles that can help to decide whether some limits on national decisions are in order. This lays the ground for an understanding of the Stability and Growth Pact. The chapter next examines the Pact's impact on policy choices and the controversies that have arisen as its shortcomings become more evident. It concludes with a presentation of a new pact, the Euro Plus Pact.

17.1 Fiscal policy in the monetary union

17.1.1 An ever more important instrument?

When joining a monetary union a country gives up one of its two macroeconomic instruments – monetary policy – but retains full control of the other – fiscal policy. Fiscal policy seems to be the way to deal with asymmetric shocks when they arise, in effect substituting for the lost monetary instrument. In this view, in the Eurozone fiscal policy becomes more important and should be used to stabilize national output and employment fluctuations and, via the Phillips curve, inflation as well. Unfortunately, fiscal policy is unlikely to be a good substitute for monetary policy. It is a very different instrument, more difficult to activate and less reliable than monetary policy. Importantly, it can be misused, and it often is misused when governments ignore the need to eventually balance their budgets.

A common problem with both instruments is that they affect spending largely through expectations. For monetary policy, as explained in Chapter 14, the central bank can only control very short-term interest rates while private spending is mostly financed through long-term borrowing. For fiscal policy, changes in public spending and/or taxes impact on the budget balance, which immediately raises the question of the financing of the public debt. Consider, for instance, a cut in income taxes designed to raise private spending. A tax cut creates a budget deficit. The government will have to borrow and increase the public debt, but how will this new debt be reimbursed? If, as is plausible, taxes are eventually raised, the policy action is properly seen as the combination of a tax reduction today and a tax increase later. This is an action unlikely to boost private consumption.[1]

Fiscal policy faces a major additional drawback: it is very slow to implement. A central bank can decide to change the interest rate whenever it deems it necessary, and can do so in a matter of seconds. Not so for fiscal policy. Establishing the budget is a long and complicated process. The government must first agree on the budget, with lots of heavy-handed negotiations among ministers. The budget must then be approved by the parliament, a time-consuming and highly political process. Then spending decisions must be enacted through the bureaucracy, and taxes can only be changed gradually as they are never retroactive. For example, income taxes can only affect future incomes, implying long delays, even though, once implemented, fiscal policy actions tend to have a more rapid effect on the economy (6 to 12 months) than does monetary policy (12 to 24 months). In the end, fiscal policy is like a tanker; it changes course very slowly.

[1] The extreme case where consumers save all of the tax reduction to pay for future tax increases is called Ricardian equivalence. It is explained, and its empirical validity assessed, in, for example, Burda and Wyplosz (2012).

The delay may even be such that, when fiscal policy finally affects the economy, the problem that it was meant to solve has disappeared.

In much the same way as unrestrained monetary policy eventually delivers inflation, undisciplined fiscal policy results in high public indebtedness. The crisis has shown that allowing debts to grow can destabilize a country and that the phenomenon may be contagious within the Eurozone. The inflation bias, the tendency to use monetary policy unwisely, has been reduced by making central banks independent from governments that tend to favour short-term gains (revenue from inflation) at the expense of long-term pain (getting rid of inflation once it has been unleashed). The same political instincts are the source of a deficit bias, which is examined in Section 17.2.4. The deficit bias remains a feature of several Eurozone countries, which calls for remedial action. This is the raison d'être of the Stability and Growth Pact, presented in Section 17.4.

17.1.2 Borrowing instead of transfers

Another way of looking at fiscal policy is that the government borrows and pays back on behalf of its citizens. During a slowdown, the government opens up a budget deficit that is financed through public borrowing. In an upswing, the government runs a budget surplus, which allows it to pay back its debt. A government that borrows to reduce taxes now and raises taxes later to pay back its debt is, in effect, lending to its citizens now and making them pay back later. Individual citizens and firms could, in principle, do it on their own, borrowing in bad years and paying back in good years. This would have the same stabilizing effect as fiscal policy. Is fiscal policy a futile exercise or, worse, a bad political trick? Not quite.

To start with, in the previous example the government simply acts as a bank vis-à-vis its citizens. The reason why it may make sense is that, when the economy slows down, lending becomes generally riskier and banks become very cautious. Many citizens and firms cannot borrow in bad times, or can only borrow at high cost. Indeed, their banks consider workers who lose their jobs as a bad risk, and so are firms that face sagging profits or even losses. When governments are considered a good risk, they can borrow at all times at reasonably low cost. This is why countercyclical fiscal policies can be effective.

An additional reason is related to one of the optimum currency area criteria examined in Chapter 15, the desirability of substantial inter-country transfers. In that dimension, Europe was found to do very poorly. Using fiscal policy can alleviate this problem. When a country faces an adverse asymmetric shock, its government can borrow from countries that are not affected by the shock. This is the equivalent of a transfer: instead of receiving a loan or a grant[2] from other Eurozone governments or from 'Brussels', the adversely affected country's government borrows. In this way fiscal policy makes up for the absence of 'federal' transfers in a monetary union.

17.1.3 Automatic stabilizers and discretionary policy actions

Automatic stabilizers

Fiscal policy has one important advantage: it tends to be spontaneously countercyclical. When the economy slows down, individual incomes are disappointingly low, corporate profits decline and spending is rather weak. This all means that tax collection declines: income taxes, profit taxes, VAT, etc. are less than they would be in normal conditions. At the same time, spending on unemployment benefits and on other subsidies rises. All in all, the budget worsens and fiscal policy is automatically expansionary. These various

[2] A grant is not to be reimbursed, but a collective system of grants implies that any country is supposed to be alternately giving and receiving, the total averaging zero over the long run. This is no different from long-term borrowing – receiving now, paying back later.

effects are called the automatic stabilizers of fiscal policy. Table 17.1 shows how much the budget balance deteriorates when the economy slows down. Roughly, on average, a 1 per cent decline in growth leads to a deterioration of the budget balance of about 0.5 per cent of GDP. There are some differences from one country to another, which reflect the structure of taxation and of welfare payments.[3] This, in turn, represents an automatic fiscal expansion.

Table 17.1 Sensitivity of government budget balances to a 1 per cent decline in economic growth

Country	%	Country	%	Country	%	Country	%
Germany	0.5	Austria	–0.5	Greece	–0.6	Portugal	–0.4
France	–0.5	Belgium	–0.5	Ireland	–0.4	Spain	–0.5
Italy	–0.4	Denmark	–0.7	Netherlands	–0.6	Sweden	–0.5
UK	–0.6	Finland	–0.5				

Source: Economic Outlook, OECD, 1997

Discretionary fiscal policy

The automatic stabilizers just happen. Discretionary fiscal policy, on the contrary, requires explicit decisions to change taxes or spending. As noted above, such decisions are slow to be made and implemented. This is why, in some countries, the budget law sets aside some funds – called rainy day funds – that can be quickly mobilized by the government if discretionary action is needed. Even then, the amounts are small and their use is often politically controversial.

An implication of the existence of automatic stabilizers is that the budget figures do not reveal what the government is doing with its fiscal policy. The budget can change for two reasons. It can improve, for example, because the government is cutting spending or raising taxes – this is called discretionary policy – or because the economy is booming – the automatic stabilizers. In order to disentangle these two factors, it is convenient to look at the cyclically adjusted budget. This procedure is based on the output gap concept. A negative gap, for instance, indicates that the economy is underperforming, that it operates below its potential. The cyclically adjusted budget balance is an estimate of what the balance would be in a given year if the output gap were zero. When output is below potential, i.e. when the output gap is negative, the actual budget balance is lower than the cyclically adjusted budget balance and conversely when the output gap is positive. The difference between the evolution of the actual and cyclically adjusted budget balances is the footprint of the automatic stabilizers.

The cyclically adjusted budget balance is a reliable gauge of the stance of fiscal policy since it separates discretionary government actions from the cyclical effects of the automatic stabilizers. An improvement indicates that the government tightens fiscal policy whereas an expansionary fiscal policy worsens the cyclically adjusted budget balance. If the government never changed its fiscal policy, the cyclically adjusted budget balance would remain constant, at least to a first approximation.[4] Box 17.1 illustrates this point in the case of the Netherlands. These two issues – the role of the automatic stabilizers and the distinction between the actual and cyclically adjusted budgets – play a crucial role in what follows.

[3] For example, the more progressive are income taxes, the more tax collection declines during a slowdown, hence the greater the stabilization effect. Similarly, the automatic stabilizers are stronger the larger are the unemployment benefits.

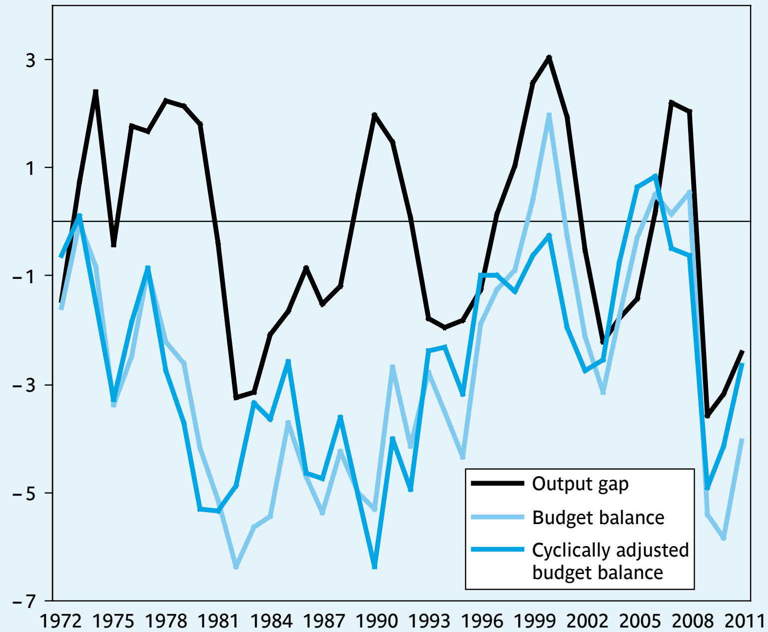
[4] Why to a first approximation? Because as the economy grows, more people climb the income ladder and face higher tax rates. Also, the structure of the economy changes, possibly changing the way taxes are collected.

Box 17.1 The automatic stabilizers in the Netherlands

Figure 17.1 displays the output gap along with the actual and cyclically adjusted budget balance of the Netherlands. We can see that the actual balance generally moves in tandem with the output gap, an indication that the automatic stabilizers are at work. Note also the steady improvement in the budget that occurred during the convergence years 1995–99. It is due partly to government efforts to meet the Maastricht conditions, as shown by the reduction of the cyclically adjusted deficit, and partly to a rising output gap that made it easier to meet the Maastricht entry condition. It is also interesting to observe that the sharp deterioration of the budget over 2001–05 – which brought the Netherlands into violation of the Stability and Growth Pact – is the consequence of a serious slowdown, and occurred in spite of visible government efforts to avoid this outcome. Then, with the financial crisis that started in 2007, the Dutch economy went into a sharp contraction; its actual deficit swung into a large deficit, most of it due to discrete action that pushed the cyclically adjusted balance sharply down, with a modest additional contribution from the automatic stabilizers.

Note that the cyclically adjusted budget, which is a measure of discretionary actions, also tends to move in the same direction as the output gap. In good years, when the output gap rises, the government conducts restrictive fiscal policies, while its policy is expansionary when the output gap declines. Put differently, fiscal policy tends to be used in a countercyclical way, which dampens the business cycle. Looking carefully at the figure shows numerous exceptions, however.

Figure 17.1 Actual and cyclically adjusted budgets in the Netherlands, 1972–2011



Note: All variables are measured as per cent of GDP.
Source: Economic Outlook, OECD

17.2 Fiscal policy externalities

17.2.1 Spillovers: a case for policy coordination

So far, the discussion has concerned individual countries. But fiscal policy actions by one country may spill over to other countries through a variety of channels such as income and spending, inflation, borrowing costs and financial distress. Such spillovers, called externalities, mean that one country's fiscal policy actions can help or hurt other countries. Countries subject to each other's spillovers stand to benefit from coordinating their fiscal policies. In principle, all concerned countries could agree on each other's fiscal policy to achieve a situation that befits them all. This is what policy coordination is about.

While, formally, fiscal policy remains a national prerogative, it is natural to ask whether the deepening economic integration among Eurozone countries calls for some degree of coordination. On the one hand, the setting up of a monetary union strengthens the case for fiscal policy coordination as it promotes deeper ties. On the other hand, fiscal policy coordination requires binding agreements on who does what and when. Such detailed arrangements would limit each country's sovereignty, precisely at a time when the fiscal policy instrument assumes greater importance. The question is whether sharing the same currency increases the spillovers to the point where some new limits on sovereignty are desirable and justified. To answer this question, we review the channels through which spillovers occur and examine what difference the Eurozone makes.

17.2.2 Cyclical income spillovers

Business cycles are transmitted through exports and imports. When Germany enters an expansion phase, for instance, it imports more from its partner countries. For these partner countries, the German expansion means more exports and more incomes. This is how the expansion tends to be transmitted across borders. Figure 17.2, which displays output gaps for a number of countries, confirms that business cycles are highly synchronized in Europe, and were so long before the adoption of the euro. Quite obviously, the spillover is stronger the more the countries trade with each other.

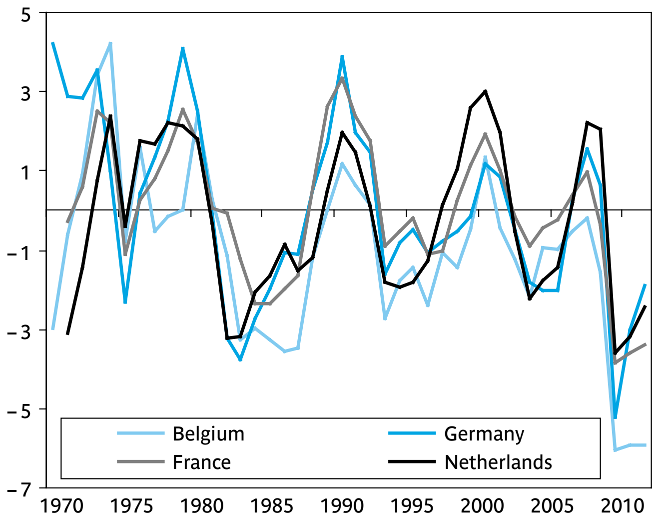
What does this mean for fiscal policy? Consider, first, the case when two monetary union member countries undergo synchronized cycles, for example both suffer from a recession. Each government will want to adopt an expansionary fiscal policy, but to what extent? If each government ignores the other's action, their combined action may be too strong as each economy pulls the other one from the recession – an effect of the Keynesian multiplier. If, instead, each government relies on the other to do most of the work, too little might be done. Consider next the case when the cycles are asynchronized. An expansionary fiscal policy in the country undergoing a slowdown stands to boost spending in the already booming country. Conversely, a contractionary fiscal policy move in the booming country stands to deepen the recession in the other country.

17.2.3 Borrowing cost spillovers

A fiscal expansion increases public borrowing or reduces public saving. As the government is usually the country's biggest borrower, large budget deficits may push interest rates up. Once they share the same currency, Eurozone member countries share the same interest rate. One country's deficits, especially if the country is large and its deficits sizeable, may impose higher interest rates throughout the Eurozone.[5] As high interest rates deter investment, they affect long-term growth. This is another spillover channel.

[5] Jürgen Stark, a high-level German official who was influential in designing the Stability and Growth Pact, writes: 'The state's absorption of resources which would otherwise have found their way into private investments results in higher long-term interest rates' (Stark, 2001, p. 79).

Figure 17.2 Income spillovers, 1970–2011



Note: The figure displays output gaps (per cent of potential GDP).

Source: *Economic Outlook*, OECD

As stated, the argument is weak. Since Europe is fully integrated in the world's financial markets, any one country's borrowing is unlikely to make much of an impression on world and European interest rates. On the other hand, heavy borrowing may elicit capital inflows. This could result in an appreciation of the euro, which would hurt the area's competitiveness and cut into growth. Borrowing costs thus represent another channel for spillovers.

17.2.4 Excessive deficits and the no-bailout clause

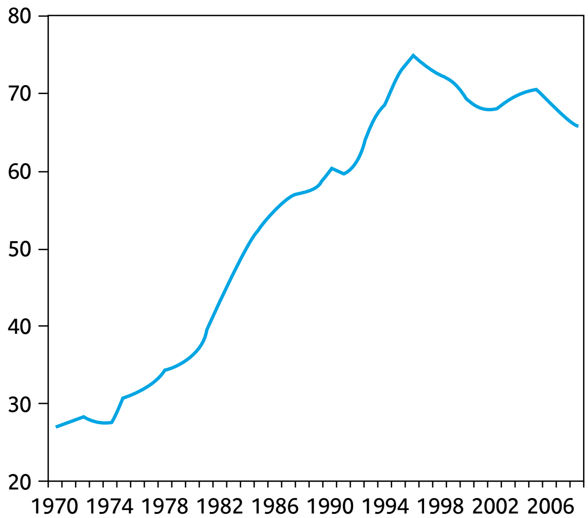
Even before the crisis, it was clear that debt sustainability could not be taken for granted in Europe. As a share of GDP, overall public indebtedness in the Eurozone had nearly tripled since 1970, as Fig. 17.3 shows.[6] In the distant past, public debts had occasionally risen but only in difficult situations, mostly during wars. The post-war debt build-up, partly related to the oil shocks of the 1970s and 1980s, illustrates what is sometimes called the 'deficit bias'. This bias reflects a disquieting tendency for governments to run budget deficits for no other reason than political expediency. Does it call for a specific collective measure?

In principle, it is in each country's interest to resist the deficit bias and there is no need for collective measures, unless spillovers can be identified. The founding fathers of the euro identified four spillovers. The first one concerns the tendency of financially hard-pressed governments to call upon the central bank to finance their deficits. Debt monetization, as this is called, is the traditional route to inflation. Central bank independence from government is the proper response and, as noted in Chapter 16, the Eurosystem enjoys very strong independence.

Second, heavy public borrowing by one country is a sign of fiscal indiscipline that could trouble the international financial markets. If markets believe that one country's public debt is unsustainable, they could view the whole Eurozone with suspicion. The result would be sizeable capital outflows and euro weakness. This potential source of spillover has not (yet?) materialized in the Eurozone.

[6] This is the debt for the whole zone. The situation differs from country to country.

Figure 17.3 Public debt of the Eurozone (% of GDP), 1970–2008



Source: Economic Outlook, OECD

There is a third potential spillover. If a government accumulates such a debt that it can no longer service it, it must default. The experience with public debt defaults is that the immediate reaction is a massive capital outflow, a collapse of the exchange rate and of the stock markets, and a prolonged crisis complete with a deep recession and skyrocketing unemployment. Being part of a monetary union changes things radically. It is now the common exchange rate that is the object of the market reaction. The spillover can further extend to stock markets throughout the whole monetary union.

A further fear is that the mere threat of one member country's default would so concern all other member governments that they would feel obliged to bail out the nearly bankrupt government. This last risk has been clearly identified in the Maastricht Treaty, which included a 'no-bailout' clause. Article 125 of the European Treaty forbids the Eurosystem – and all other public institutions, including governments – from providing direct support to other Eurozone governments. Yet, it always was an open question whether, in the midst of an emergency, some arrangement could still be found to bail out a bankrupt government. For example, the ECB could be 'informally' pressed to relax its monetary policy to make general credit more abundant at a lower cost, which would result in inflation. More generally, it was feared that a sovereign default would badly affect the Eurozone and undermine its credibility. We will see in Chapter 19 that the no-bailout clause was ignored in May 2010.

17.2.5 The deficit bias and collective discipline

Why do governments seem to have a deficit bias, and why does this bias seem to differ from country to country, as can be seen in Table 17.2? Deficits allow governments to deliver goods and services today without facing the costs, passing the burden of debt service to future governments or even to future generations. It is tempting to do so, especially when elections are near; but adequate democratic accountability should prevent governments from indulging. Even though future generations are not here to weigh in, the current generation may reasonably expect to be called upon to service the debt, and anyway most people care about the next generation. So a debt build-up often reflects a failure of democratic control over governments. Why has this been happening in Europe's democracies?

Table 17.2 Public debts in Europe (% of GDP), 2011

Austria 73.8	Belgium 97.0	Bulgaria 18.0	Cyprus 62.3	Czech Rep. 41.3	Denmark 45.3
Estonia 6.1	Finland 50.6	France 84.7	Germany 82.4	Greece 157.7	Hungary 75.2
Ireland 112.0	Italy 120.3	Latvia 48.2	Lithuania 40.7	Luxembourg 17.2	Malta 68.0
Netherlands 63.9	Poland 55.4	Portugal 101.7	Romania 33.7	Slovakia 44.8	Slovenia 42.8
Spain 68.1	Sweden 36.5	UK 84.2		EU27 82.3	Eurozone 87.7

Source: AMECO, European Commission

Public spending is an important source of income for all sorts of citizens, organizations and firms. Taxpayers, current or future, must pay for it. Those who receive money from the government hope that they will not pay the corresponding taxes, or not fully. It is in the interest of every recipient of public spending to ask for more. In fact, they often form well-organized and influential interest groups. Democratically elected governments are naturally inclined to please the interest groups without raising taxes. The result is a widespread bias towards deficits. The importance of the bias depends on the electoral process. For instance, parliamentary regimes that involve large coalitions seem to be doing less well at keeping deficits in check.

Changing the democratic regime (the form of democracy, how elections are organized) could help, but it is a rather intractable endeavour. This is why some governments find it appealing to seek external restraint and to invoke 'Brussels' as a scapegoat that can be blamed when resisting interest groups and political friends. Collective discipline, even if not necessarily justified by spillovers, can be used as a substitute for adequate domestic institutions.

17.3 Principles

The existence of spillovers is one argument for sharing policy responsibilities among independent countries. It is not the only argument, however, and there are powerful counter-arguments. The broader question is, at which level of government – regional, national, supranational – should policies be conducted? The theory of fiscal federalism deals with this question. The principle of subsidiarity is another way of approaching the issue. Both approaches were presented earlier, in Chapter 3, and are briefly recalled in this section.

17.3.1 Fiscal federalism

The theory of fiscal federalism asks how, in one country, fiscal responsibilities should be assigned between the various levels (national, regional, municipal) of government. It can be transposed to Europe's case, even though Europe is not a federation, by asking which tasks should remain in national – possibly regional in federal states – hands and which ones should be a shared responsibility, i.e. delegated to Brussels. There are two good reasons to transfer responsibility to Brussels and two good reasons to keep it at the national level. An additional concern is the quality of government at the national and supranational level.

Two arguments for sharing responsibilities: externalities and increasing returns to scale

As noted before, spillovers, also called externalities – when one country's actions affect other countries – lead to inefficient outcomes when each country is free to act as it wishes. Sometimes too much action is taken, sometimes not enough. This is the case of tariffs (see Chapter 4) and it concerns fiscal policy as well. The other argument is that some policies are more efficient when carried out on a large scale. Increasing returns to scale can be found in the use of money,[7] in the design of commercial law or in defence (army, weapons development and production), among others.

One solution is coordination, which preserves sovereignty but calls for repeated and often-piecemeal negotiations, with no guarantee of success. Another solution is to give up sovereignty, partly or completely, and delegate a task to a supranational institution. In Europe, some important tasks have already been delegated to the European Commission (the internal market and trade negotiations) and to the Eurosystem (monetary policy).

Two arguments for retaining sovereignty: heterogeneity of preferences and information asymmetries

Consider the example of common law concerning family life (marriage and divorce, raising children, dealing with ageing parents, etc.). Practices and traditions differ across countries, sometimes to a considerable extent. In this domain, preferences are heterogeneous and a supranational arrangement is bound to create much dissatisfaction.

Now consider the decisions of where to build roads, how large to make them, where to set up traffic lights, etc. These require a good understanding of how people move, or wish to move, in a geographic area. It is a case of information asymmetry: the information is more readily available at the local level than at a more global level.

Heterogeneity of preferences and information asymmetries imply that, in these matters, it would be inefficient to share competence at a supranational level. Much of the criticism levelled at 'Brussels' concerns cases where either heterogeneity or information asymmetries are important: deciding on the appropriate size of cheese or the way to brew beer is best left to national governments, even to local authorities, no matter how important the externalities or increasing returns to scale.

The quality of government

An implicit assumption so far is that governments always act in the best interest of their citizens. While this may generally be the case, there are numerous instances when governments either pursue their own agendas or are captured by interest groups. In addition, like any institution, governments often wish to extend their domain of action, possibly in order to increase their own power or because they genuinely believe that they do a better job than lower-level jurisdictions. One can question whether there is such a thing as 'the best interest of citizens': some citizens favour some actions, others do not. Governments exist in part to deal with such conflicts and do so under democratic control, but elections cannot sanction every one of the millions of decisions that favour well-connected interests. In spite of all the good things that can be said about democracy, it is not a perfect system.

[7] Chapter 15 explains why this is a key benefit from forming a currency area.

What to conclude?

There are good reasons for centralizing some tasks and other good reasons for decentralizing other tasks. The theory of fiscal federalism does not provide a general answer; rather it argues in favour of a case-by-case approach and suggests that, often, we face trade-offs with no compelling answer. To make things even murkier, the observation that governments are not perfect, just human, means that we need always to keep in mind that a good solution may turn out to be bad if the government is misbehaving. In particular, the quality of government and of democratic control ought to be brought into the picture. The practical question here is whether Brussels performs better than the national governments.

17.3.2 The principle of subsidiarity

It should be clear by now that the four arguments for and against centralization at the EU level are unlikely to lead to many clear-cut conclusions, and the warning about the quality of government further complicates the issue. Weighing the various arguments and trading off the pros and cons is often mission impossible, hence another question: where should the burden of proof lie? The EU has taken the view that the burden of proof lies with those who argue in favour of sharing sovereign tasks. This is the principle of subsidiarity (presented in Chapter 3) and it is enshrined in the European Treaty:

> *"In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community."*
>
> (Article 5)

In other words: unless there is a strong case of increasing returns to scale or of externality, the presumption is that decisions remain at the national level.

17.3.3 Implications for fiscal policy

A key distinction: micro- vs. macroeconomic aspects of fiscal policy

It is helpful to separate two aspects of fiscal policy. The first aspect is structural, that is, mainly microeconomic. It concerns the size of the budget, what public money is spent on, how taxes are raised, i.e. who pays what. It also concerns income redistribution, designed to reduce inequalities or to provide incentives to particular individuals or groups. The second aspect is macroeconomic. This is the income stabilization role of fiscal policy, the idea that it can be used as a countercyclical instrument.

Here, we focus on the macroeconomic stabilization component of fiscal policy, ignoring the structural aspects, which clearly are a matter for national politics, with very limited macroeconomic impact. To simplify, we look at the budget balance and ignore the size and structure of the budget and the resulting evolution of the public debt. We apply the principles of fiscal federalism to ask whether there is a case for limiting the free exercise of sovereignty on national budget balances and debts.

The case for collective restraint

Section 17.2 identifies a number of spillovers: income flows, borrowing costs and the risk of difficulties in financing runaway deficits, possibly leading to debt default. Some of these spillovers can have serious effects across the Eurozone, as the crisis has shown. In addition, some countries have not established political institutions that are conducive to fiscal discipline so it may be in their own best interest to use Brussels as an external agent of restraint. On the other hand, it is difficult to detect any scale economy.

These externalities call for some limits on national fiscal policies, and such limits can take various forms, ranging from coordination and peer pressure to mandatory limits on deficits and debts.

The case against collective restraint

Working in the opposite direction are important heterogeneities and information asymmetries. Macroeconomic heterogeneity occurs in the presence of asymmetric shocks. A common fiscal policy, on top of a common monetary policy, would leave each country without any countercyclical macroeconomic tool. Heterogeneity can also be the consequence of differences of opinions regarding the effectiveness of the instrument. Some countries (e.g. France and Italy) have long been active users of fiscal policy whereas others (e.g. Germany) have a tradition of scepticism towards Keynesian policies. Finally, national political processes are another source of heterogeneity. In some countries, the government has quite some leeway to adapt the budget to changing economic conditions, whereas in others the process is cumbersome and politically difficult.

Information asymmetries chiefly concern the perception of the political implications of fiscal policies. Each government faces elections, and economics is often an important factor shaping voter preferences. Whether and how to use fiscal policy at a particular juncture is part of a complex political game, which makes national politics highly idiosyncratic. While governments have a lot of understanding for each other's electoral plight, they have a hard time absorbing all the fine details of foreign national politics.

Overall

It is far from clear that the macroeconomic component of fiscal policy should be subject to common limits. Quite clearly, a single common fiscal policy is ruled out, but what about some degree of cooperation? The debate is ongoing and is unlikely to be settled in the near future. The subsidiarity principle implies that, as long as the case is not strong, fiscal policy should remain fully a national prerogative. On the other hand, the spillover that could result from *excessive* deficits is important, and it forms the logical basis for the Stability and Growth Pact.

17.3.4 What does it all mean for fiscal policy in the Eurozone?

In true federal states, there is a powerful federal level of government and sub-federal governments are restrained in their ability to run deficits and hence to use fiscal policy as a macroeconomic instrument. In the Eurozone, instead, the Commission budget is far too small (1 per cent of GDP) to play any macroeconomic role. This is why a number of proposals aim at an 'economic government for Europe', including a European Finance Minister. The idea is that decentralized fiscal policies would be subject to overall coherence objectives. There is a strong logic to it, but how does it deal with sovereignty in fiscal matters?

Applying the principles of fiscal federalism to the Eurozone leaves us with few uncontroversial conclusions. There always were valid reasons for imposing fiscal discipline, and the debt crisis has made it clear that it is a survival condition for the euro. The case for policy coordination is also convincing but there are equally valid arguments in the opposite direction. All in all, the case for further transfers of sovereignty is weak.

Start with fiscal discipline. Since one country's lack of fiscal discipline may create havoc throughout the Eurozone, as has happened, a natural reaction is to seek to limit the sovereignty of member countries, at least during periods of instability. At the same time, parliamentary control over budgetary matters is a very fundamental principle of democracies ('no taxation without representation'). Challenging this principle can be justified only if there is no other way of imposing fiscal discipline through member countries. But, as explained in Box 17.2, a number of countries have alleviated their own deficit biases by reforming their budgetary processes. This indicates that national solutions can deliver fiscal discipline.

There is no doubt that policy coordination is desirable, but it is also very difficult to implement. Ideally, all governments would discuss their macroeconomic needs and the Eurosystem would indicate its contribution to overall inflation and output stabilization. Then the governments would agree on what each one would do both to deal with domestic conditions and to achieve the collective best. This is a tall order. First, because assessing each country's needs and identifying the collective best is largely beyond current knowledge. Second, because in each country the politics of fiscal policy are often conflictual. Often the outcome of the budgetary process is unpredictable until the parliament has finished voting. Finally, governments are likely to be highly reluctant to give up an important political tool.

A step has been taken in 2011 with the adoption of a 'European semester'. In January of each year, the European Commission presents its Annual Growth Survey, which includes forecasts and an evaluation of member countries' economic situation. This triggers discussions among governments and in the European Parliament. Following recommendations by the Council in March, in April every government submits to the Commission their Stability and Convergence Programmes. Along with other policy objectives, the programmes include 'medium-term budgetary strategies', essentially a statement of intentions that cover the next three years. The Commission then assesses the national programmes and submits its conclusions and recommendations in time for a June Council. The Council's own assessment is meant to shape the next steps, when budgetary proceedings revert back to the national level. Time will tell whether the European Semester succeeds in injecting some degree of coordination effective enough to take into account the spillovers described in Section 17.2. Since this new coordination mechanism does not limit national sovereignty in any way, it is hard to imagine that much will be gained.

Box 17.2 The deficit bias and the common pool effect

The deficit bias is a frequently observed feature of otherwise well-functioning democracies. Is there a systematic reason for this tendency? The common pool effect provides a convincing interpretation. It refers to a medieval practice: villages included a publicly owned field – the commons – where peasants could freely bring their cows and sheep to pasture. Each peasant had an incentive to bring as many animals as possible since grass was free. The (possibly inaccurate) result was that the commons could not feed all the animals that were grazing. Collectively, the peasants should limit the number of animals that anyone could bring but individually each peasant wanted the others to take the first step. Herds were decimated and the peasants starved.

Much the same applies to taxation: let the others pay more! It also applies to government spending: I want more public spending that is a benefit to me, so cut spending elsewhere if need be. In a democracy, voters require governments to do things for them and to pay for them with taxes paid by the others. They often get organized in powerful pressure groups that lobby the government. In that way, many spending items become political sacred cows and tax increases are known to be politically dangerous. Budget deficits emerge as a natural outcome.

Once the source of the problem is identified, a solution can be envisioned. At the heart of the common pool effect lies the budget process; the governments are politically unable to resist pressures by interest groups. The solution is to straighten up the budget process. Some countries legally limit the size of deficits; in others the government is required to decide on the deficit first, and only then to decide on spending and taxes, yet other approaches request a high degree of transparency, which undermines the influence of lobbies. This is why the deficit bias is not a universal feature.

Table 17.3 documents the track record among developed countries. For each country, it provides two pieces of evidence: in the first row, the proportion of years when the budget was in deficit over more than half a century and, in the second row, which year the budget was last seen in surplus, if that happened after 1960. The deficit bias is widely confirmed as most countries have experienced deficits for at least four years out of five. The exceptions are Norway (which benefits from huge oil and gas income), Denmark, Finland, New Zealand and Sweden, countries that display a high degree of transparency and of collective responsibility. It is also interesting to note that some countries have recently adopted some of the anti-bias solutions mentioned above; while their track record is poor, it is improving as indicated by recent surpluses.

Table 17.3 Per cent years of deficit over 1960–2011 in the OECD area

	Australia	Austria	Belgium	Canada	Germany
Percent	80%	82%	96%	76%	78%
Last surplus	2008	1974	2006	2007	2008
	Denmark	**Spain**	**Finland**	**France**	**UK**
Percent	48%	78%	20%	90%	84%
Last surplus	2008	2007	2008	1974	2001
	Greece	**Ireland**	**Italy**	**Japan**	**Netherlands**
Percent	80%	80%	100%	68%	88%
Last surplus	1972	2007		1992	2008
	Norway	**New Zealand**	**Portugal**	**Sweden**	**USA**
Percent	4%	46%	100%	42%	92%
Last surplus	2011	2008		2008	2000

Note: Sample starts later for Australia (1962), Canada (1961), Spain (1962) and Portugal (1977).
Source: Economic Outlook, OECD and Eichengreen and Wyplosz (1993) for older data

In the end, the debate has been around for a decade and is not likely to disappear for some time.[8] It pits those who attach much importance to spillovers and think that macroeconomic coordination is both promising and relatively easy to implement against those who see coordination as a collusion of self-interested governments.

17.4 The Stability and Growth Pact

17.4.1 From convergence to the quest for a permanent regime

As explained in Chapter 16, admission to the monetary union requires a budget deficit of less than 3 per cent of GDP and a public debt of less than 60 per cent of GDP, or declining towards this benchmark. But what about afterwards, in the permanent monetary union regime? Could countries achieve the two fiscal criteria, join the monetary union and then freely relapse into unbridled indiscipline? This would be against the spirit of convergence. The founding fathers of the Maastricht Treaty were keenly aware of this risk and, indeed, Article 126 unambiguously

[8] Some references are provided in the further reading section at the end of this chapter.

states that 'Member States shall avoid excessive government deficits' and goes on to outline a detailed 'excessive deficit procedure'. The Treaty left the practical details of the procedure to be settled later – and this is the task fulfilled by the Stability and Growth Pact (SGP).[9]

Adopted in 1997, the SGP was meant to be strictly enforced. However, because fiscal policy remains a national competence, the final say was given to ECOFIN, the council of Finance Ministers of the Eurozone, acting on proposals from the Commission. The Commission has assumed the responsibility of being the Pact's 'tough cop', but ECOFIN has been loath to make decisions that would strongly antagonize its members, especially the Finance Ministers from the large countries. In November 2003, France and Germany were to be sanctioned. Under pressure from the French and German Finance Ministers, ECOFIN recanted and put the SGP 'in abeyance'. The Commission took ECOFIN to the Court of Justice of the European Communities for violation of the Pact, an unprecedented action. In June 2004, the Court decided that ECOFIN had indeed breached the law but only because of the phrasing of its decision (the SGP cannot be put in abeyance). A new resolution quickly corrected the error, without changing the fact that France and Germany had not been sanctioned. This episode confirmed the view that the SGP was not well designed. Recognizing that it was too rigid to be enforceable, governments and the Commission prepared a reformulation of the Pact. The new version was adopted in June 2005.

Then came the great financial crisis. At the time of writing, 15 of the 17 Eurozone Member States have been found to be in excessive deficit. Obviously, this was not the time to insist on a strict application of the SGP. The Commission issued a European Economic Recovery Programme, which implicitly accepted that it would take time to revert to the 3 per cent deficit limit. It explicitly set 2013 as the target date for the limit to be enforced again. At the same time, the Commission proposed to strengthen and expand the Pact, acknowledging that it had not delivered its promises before the crisis. The proposal, informally adopted in 2011, is presented in Section 17.4.4.

17.4.2 The Pact

The SGP consists of four elements:

1. A definition of what constitutes an 'excessive deficit'.
2. A preventive arm, designed to encourage governments to avoid excessive deficits.
3. A corrective arm, which prescribes how governments should react to a breach of the deficit limit.
4. Sanctions.

The SGP applies to all EU member countries but only the Eurozone countries are subject to the corrective arm.

Excessive deficits

The SGP considers that deficits are excessive when they are above 3 per cent of GDP. The Pact also stipulates that participants in the monetary union commit themselves to a medium-term budgetary stance 'close to balance or in surplus'. The medium term is understood to represent about three years. The SGP recognizes that serious recessions, beyond any government control, can quickly lead to deepening deficits. Trying to close down deficits during a recession implies

[9] The initiative was taken by Germany in 1995 and the Pact adopted in June 1997 by the European Council. Informed by its own inter-war history, Germany was always concerned that fiscal indiscipline could lead to inflation. This is why it insisted on a clear and automatic procedure. It wanted to make full use of the provisions of the Maastricht Treaty, which allowed for fines in the case of excessive deficits. The other countries were less enthusiastic but Germany was holding the key to the Eurozone. France, in particular, was unhappy with the German proposal. It obtained the symbolic addition of the word 'growth' to what Germany had initially called the Stability Pact.

adopting a contractionary policy, which may deepen the recession, with potentially disastrous consequences. Consequently, the Pact defines exceptional circumstances when its provisions are automatically suspended. A deficit in excess of 3 per cent is considered exceptional if the country's GDP declines by at least 2 per cent in the year in question. The SGP also identifies an intermediate situation, when the real GDP declines by less than 2 per cent but by more than 0.75 per cent. In that case, if the country can demonstrate that its recession is exceptional in terms of its abruptness or in relation to past output trends, the situation can also be deemed exceptional. When output declines by less than 0.75 per cent, no exceptional circumstance can be claimed.

The experience of 2001–03 showed that shallow but long-lasting slowdowns, not qualifying as exceptional, could gradually seriously deepen the deficit. In such a situation, respecting the pact would require that the automatic stabilizers be prevented from operating; this could turn a shallow slowdown into a serious recession. Deepening an ongoing recession is not attractive for real-life governments, which started to complain that the SGP was too rigid.

This is why the 2005 version of the SGP introduced two elements of flexibility. First, it admitted that a negative growth rate or an accumulated loss of output during a protracted period of very low growth might be considered as exceptional. Second, it suggested taking account of 'all other relevant factors'. In contrast to the 3 per cent limit and the –2 and –0.75 per cent definition of exceptional circumstances, these new elements are vaguely specified. In particular, the notion of 'all other relevant factors' opened the door to a flexible interpretation of the SGP.

The preventive arm

As explained in Section 17.2.4, many governments exhibit a deficit bias because of domestic pressure and political expediency. The SGP can exert counter-pressure in the form of peer pressure, called mutual surveillance. The preventive arm is designed to submit Finance Ministers to a collective discussion of one another's fiscal policy in the hope that this will help with budgetary discipline. This preventive arm is meant to prevent the need for the use of the corrective arm and its politically sensitive sanctions.

In practice, each Eurozone government submits a Stability Programme early each year. The document presents the government's budget forecast for the current year and the next three years. If the deficit is expected to exceed 3 per cent of GDP, the programme also explains what actions will be taken to correct this violation of the SGP. The Commission examines each programme, including its detailed technical aspects, and submits its individual assessments to ECOFIN. Each assessment must include an evaluation of whether the planned budgets are consistent with the SGP and whether previous commitments have been honoured. The Commission may also point out technical errors, for instance overoptimistic forecasts. ECOFIN then delivers an opinion, adopted by qualified majority. The opinion can include the recommendations prescribed by the corrective arm. All these documents are made public.[10]

EU member countries that are not part of the Eurozone must still submit their fiscal plans as part of the so-called Convergence Programmes. The content of these programmes and the procedure is the same as in the case of the Stability Programmes, with the difference that ECOFIN cannot impose sanctions; it can only issue recommendations. However, for the countries that are aiming to join the monetary union, failure to comply with the SGP implies a violation of the budgetary entry criteria.

The corrective arm

When a country does not meet the requirements of the SGP, ECOFIN applies gradually increasing peer pressure. The process starts with an 'early warning'. Early warnings are issued when ECOFIN

[10] The stability programmes are available at: http://ec.europa.eu/economy_finance/sgp/convergence/index_en.htm.

concludes that a country is likely to see its deficit become excessive. A country given an early warning is also presented with recommendations – which may or may not be made public. The forewarned country is expected to follow these recommendations. An early warning clearly puts a country on the spot, which is bound to be deeply politically embarrassing, especially as the recommendations are unavoidably perceived as an infringement of national sovereignty. This is why an early warning can be described as a political hand grenade.

The next step is the excessive deficit procedure (EDP). The procedure is triggered by an ECOFIN opinion formally stating that a country's budget is in excessive deficit. ECOFIN simultaneously issues recommendations – following suggestions from the Commission – which the country must follow. The country is expected to prepare corrective measures promptly, which are examined by the Commission. The Commission submits its assessment to ECOFIN, which may or may not be satisfied with the proposed measures. Clearly, in this situation, the government loses some autonomy. A mandatory recommendation can be seen as a political conventional bomb.

If the deficit does not diminish below the 3 per cent limit, more recommendations, increasingly pressing and tight, can be issued. In the end, if the country remains in excessive deficit, sanctions are to be imposed by ECOFIN, as explained below. Whereas the initial SGP established a precise set of deadlines, the 2005 revision allowed for quite some flexibility, at the discretion of ECOFIN.

Sanctions

If a country fails to take corrective action and bring its deficit below 3 per cent by the deadline set by the Council, it is sanctioned. A sanction can be seen as a political nuclear bomb. The sanction takes the form of a non-remunerated deposit at the Commission. The deposit starts at 0.2 per cent of GDP and rises by 0.1 of the excess deficit up to a maximum of 0.5 per cent of GDP, as shown in Table 17.4. Deposits are imposed each year until the excessive deficit is corrected. If the excess is not corrected within two years, the deposit is converted into a fine, otherwise it is returned.

Table 17.4 Schedule of fines

Size of deficit (% of GDP)	Amount of fine (% of GDP)
3	0.2
4	0.3
5	0.4
6+	0.5

Several aspects of the SGP are noteworthy. First, formally, it does not remove fiscal policy sovereignty. Governments are in full control; they only agree to bear the consequences of their actions. Second, the intent is clearly pre-emptive since there is a lengthy procedure between the time a deficit is deemed excessive and the time when a deposit is imposed, with two more years before the deposit is transformed into a fine. Third, while a fine is politically a nuclear bombshell, the declaration that a country is in violation of the Pact is a conventional bombshell, meant to elicit prompt corrective action. Finally, all decisions are in the hands of the Council, a highly political body that can exploit many of the 'ifs' included in the Pact.

17.4.3 The Pact and countercyclical fiscal policies: how much room to manoeuvre?

The automatic stabilizers

The automatic response of budget balances to cyclical fluctuations, recalled in Section 17.1.3, is a source of difficulty for the SGP because much of its machinery, including the sanction mechanism, focuses on the 3 per cent deficit limit. The logic is that, in normal years, budgets should be balanced to leave enough room for the automatic stabilizers come into play in bad years without breaching the 3 per cent limit. Box 17.3 provides an idea of what this entails.

Discretionary policy

Countercyclical fiscal policy – the use of the budget to cushion business cycles – does not have to be confined to the automatic stabilizers. Governments can avail themselves of much more room to carry out discretionary policy by running a budget surplus, possibly a large one, in normal years. This is also shown in Box 17.3. The conclusion is that surpluses have to be even larger in good years if fiscal policy is to be used energetically in bad years. The preventive arm is to be used to that effect.

Bringing budgets to the safe zone? Staying there?

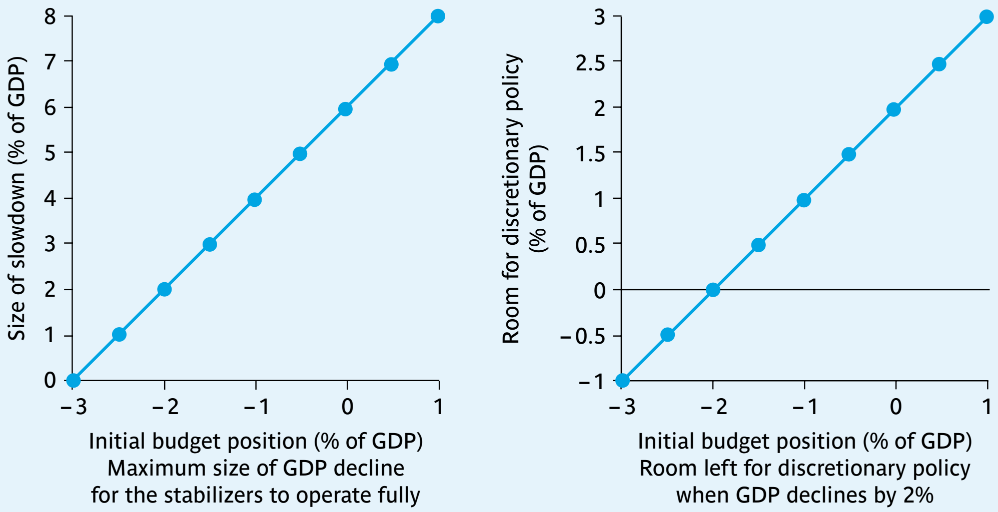
The SGP is intentionally designed to provide a strong incentive for each government to bring its budget to a position of balance, or even surplus in good years. According to its promoters, when this is achieved, monetary union member countries will have recovered almost all the required

Box 17.3 Good years, bad years, and the 3 per cent deficit limit

How to avoid using fiscal policy at cross-purposes and yet respect the SGP? When the economy slows down, the budget worsens. In order to avoid breaching the 3 per cent limit, the government could have to cut spending or raise taxes, which means adopting a contractionary policy stance when the opposite is needed to dampen the slowdown. The Pact's response is the preventive arm, the idea that the budget should be brought into surplus in good years in order to allow for a fiscal expansion in bad years without trespassing the limit. A simple example illustrates the idea. Table 17.1 shows that, on average, a 1 per cent decline in GDP growth tends to worsen the budget deficit by 0.5 per cent of GDP. Using this rough estimate, the left-hand panel of Fig. 17.4 shows how much, depending on the initial budget position, the GDP can decline before the automatic stabilizers bring the budget to a deficit of 3 per cent. Obviously, if the budget is already at the 3 per cent limit (the leftmost point on the horizontal axis), there is no room available and the stabilizers must be blocked – fiscal policy becomes pro-cyclical – independently of the size of the slowdown (the zero on the vertical axis). If, instead, the budget were initially balanced (the zero on the horizontal axis), it would take a fall of 6 per cent of GDP (read off the vertical axis) to reach a deficit of 3 per cent. In comparison, the GDP decline that has led France and Germany to breach the limit in 2003 was about 2 per cent.

Figure 17.4 also illustrates the discrete use of fiscal policy. The right-hand chart asks the following question: Suppose that GDP declines by 2 per cent, what is left for a further discretionary fiscal expansion over and above the automatic stabilizers? Using the same rule of thumb as in the left-hand panel, we know that the stabilizers worsen the budget by 1 per cent of GDP. The remaining room for manoeuvre depends again on the initial budget position. The graph shows that if the budget was, for instance, in a surplus of 1 per cent (to be read off the horizontal axis), the government can voluntarily increase spending, or cut taxes, to the tune of 3 per cent of GDP (the top reading on the vertical axis).

Figure 17.4 Room for manoeuvre in the Stability and Growth Pact



room for manoeuvre. Only deep recessions will prevent the countercyclical use of fiscal policy, and deep recessions will qualify as exceptional.

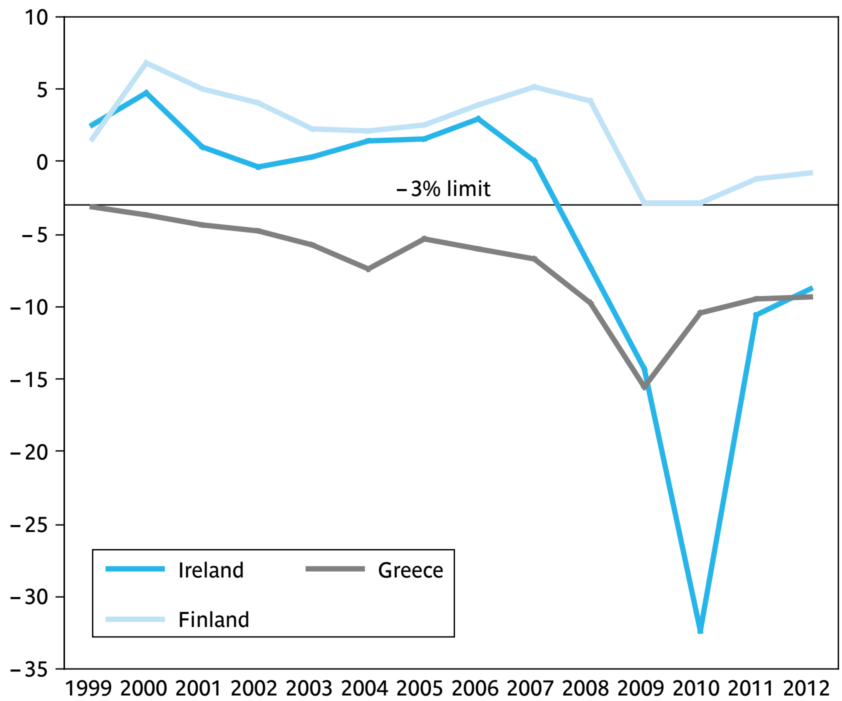
As it turned out, the early years of the euro were characterized by a moderate slowdown, followed after 2003 by the years of the Great Moderation, a period of continuous growth and low inflation. Three cases are presented in Fig. 17.5. Finland offers an example of a successful application of the SGP strategy. It started with a budget surplus, which shrank with the slowdown but expanded in the good years. In 2006, just before the crisis, the surplus amounted to 5.3 per cent of GDP. This left ample space for a deterioration without crossing the 3 per cent deficit line. Ireland did about as well, but the bursting of its housing bubble forced a whopping deficit of more than 30 per cent of GDP in 2010 as the government scrambled to prevent a collapse of the banking system. This is a clear case of an exceptional circumstance. Greece, on the other hand, started with a large deficit – having hidden its true situation to gain entry into the euro area – and did not use the good years to correct the situation. By 2006, the deficit stood at 6 per cent of GDP and plunged deeply when the crisis provoked a deep recession.

Controversies

The public debt crisis sweeping through the Eurozone provides ammunition to those who have been arguing that the SGP is not likely to achieve its aim of firmly establishing fiscal discipline in each and every member country. Yet, the debt crisis can be seen as the consequence of the preceding exceptional financial crisis, a one-in-a-lifetime event. The Pact was not designed for such circumstances; indeed it includes an 'exceptional circumstance' clause. Still, the Pact's history is disturbing.

The difficulties met in trying to enforce the SGP are in line with the observations presented above in Section 17.3.4. The benefits from coordination are limited, the collective need for discipline is high, but collectively enforced discipline clashes with national sovereignty. This conflict is unavoidable. Discipline cannot be enforced without the threat of sanctions. In the

Figure 17.5 Budget balances since 1999 (% of GDP)



Source: AMECO, European Commission

same spirit as nuclear deterrence – the cost of an attack would be so great that no attack will be undertaken – the initial version of the SGP sought to make sanctions automatic, precisely to avoid a situation where sanctions would actually be imposed. Some small countries were put on the spot, as is explained further below, but the two largest countries called its bluff and the Pact caved in. These events exposed a latent rift between large and small countries, which complicated subsequent negotiations. The SGP was reformed in 2005 but without resolving the logical conflict that lies at its heart. While the revision upheld the principle of sanctions, it clearly sought to avoid a situation where sanctions would have to be applied. The next version, mooted in 2011, seeks to make sanctions as automatic as possible. It is presented in Section 17.4.4.

17.4.4 Euro Plus: a strengthened Stability and Growth Pact

As the debt crisis was developing and the limits of the SGP came to be officially recognized, a new reform was informally adopted in 2011 under the name of Euro Plus Pact. It remains to be made precise and definitely adopted.[11] The aim is to strengthen and expand the Pact, in effect reversing the 2005 reform, which instead tried to make it less rigid because at that time it was found politically too difficult to implement. Interestingly, the newly proposed arrangement makes no reference to the no-bailout clause; overlooking this clause during the crisis has removed a key instrument to collectively impose fiscal discipline within the Eurozone.

[11] The Pact has been agreed by the Eurozone member countries, joined by Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. Its precise formulation has not been finalized at the time of writing; what follows is therefore likely to depart from the end result.

The deficit target

The 3 per cent limit is artificial: Why 3 per cent and not 2 or 3.5 per cent? In addition, targeting the budget balance is like shooting at a moving duck: it changes all the time as economic conditions evolve, and it is therefore beyond government control. The answer, already sketched in the 2005 reform, is to target instead the cyclically adjusted primary budget balance, also called the structural budget balance, which captures discretionary actions. The structural budget involves two adjustments. The primary budget excludes interest payments on the existing debt. The actual budget deficit exceeds the primary budget by the amount of interest payments; when the primary budget is balanced, the actual budget exhibits a 3 per cent deficit if interest payments amount to 3 per cent of GDP, which is the case on average within the Eurozone. The second adjustment concerns cyclical fluctuations, which increase (during bad years) or decrease (in good years) the actual deficit.

The new pact requires that cyclically adjusted primary budgets be balanced. The intention is to achieve a primary budget that is balanced on average over a business cycle, thus allowing the countercyclical discretionary use of fiscal policy. Even if this is achieved, however, the debt may not be reduced over time, as explained in Box 16.1. This is why the new pact also looks at the public debt.

The debt target

Let us take a step back and ask: Why do we care about fiscal discipline in the first place? The answer is that a prolonged lack of discipline eventually leads to a debt default (see Section 17.2.4). The natural implication is that the SGP should target the debt-to-GDP ratio. As long as this ratio declines or remains at a moderate level, there is no threat of default. A debt that keeps increasing, year in, year out, is unsustainable. To be sustainable the debt, measured as a proportion of GDP, must either be stabilized at a comfortable level or eventually brought down to a comfortable level. Why should it be measured as a proportion of GDP and what is a comfortable level? First, a public debt is guaranteed by the ability of the government to raise adequate taxes; national taxable income is approximated by the GDP. Second, we do not know what is a comfortable debt level, nor is there any generally accepted prescription for a desirable debt level. A large debt carries two serious drawbacks: (1) taxes must be raised to serve the debt; (2) any slippage – as was unavoidable during the crisis – means that the debt can rise to worrying heights, which can make it difficult to borrow from nervous financial markets. A low debt level is clearly preferable to a high debt level, but there is no clear boundary between 'too big' and 'small enough'.

The EDP, as described in the Maastricht Treaty, refers to both the annual deficit (limit set at 3 per cent of GDP) and the public debt (limit set at 60 per cent of GDP). The SGP so far has made only a passing reference to the debt; it focused instead on the deficit figure. The initial intention was to require that debts do not exceed 60 per cent of GDP, which was then the European average. By end 2011, the debt average is close to 90 per cent and the old target is beyond reach for many years to come. The new pact does not pretend to make the 60 per cent mark an objective. Instead, reasonably, it states that the evolution of the debt will be one criterion used to evaluate policies.

Sanctions

If the SGP is to have any influence on governments subject to the deficit bias, it must be backed by credible sanctions. When the SGP was under discussion, one view was that it should be entirely automatic, with each step, including sanctions, to be decided by the Commission on the basis of a transparent and unambiguous roadmap. On the other hand, fiscal policy remains an element of national sovereignty. In every democracy, deciding who will pay taxes and how much, and how public money is to be spent, is in the hands of elected officials. An automatic application of the SGP, including detailed mandatory recommendations, would clearly violate this basic principle of democracy. This is why, in the end, enforcement of the SGP was entrusted to ECOFIN, the Council of Economic and Finance Ministers.

Acting on recommendations from the European Commission, ECOFIN decides by a majority of its members whether to apply the measures provided for by the Pact: early warnings, policy recommendations, application of the EDP and, in the end, the imposition of fines. But Finance Ministers are, by definition, politicians. As such, they make elaborate calculations involving tactical considerations often far away from the principles discussed here, as the various cases described in Box 17.4 illustrate. The Euro Plus Pact intends to make the decision procedure much more certain and automatic. If the pact is put into place, the Commission recommendations will be automatically accepted unless a qualified majority (two-thirds of the vote) decides to the contrary.

Box 17.4 Ten years of the Stability and Growth Pact

Over the first ten years of monetary union, the excessive deficit procedure (EDP) has been triggered 22 times for Eurozone members, which are subject to sanctions, and an additional 12 times for other EU countries, which cannot be fined (see Table 17.5). Yet, sanctions have never been imposed. This can be seen as proof that the SGP has been effective at restraining fiscal indiscipline, with a soft touch. Alternatively, it can be that ECOFIN, which makes decisions, has never been ready to sanction a fellow government. A few odd episodes, which spurred considerable controversies, are recalled here.

Table 17.5 Excessive deficit procedures since 1999

Austria	2009		
Belgium	2009		
Cyprus	2010		
France	2003	2009	
Germany	2003	2009	
Greece	2004	2009	
Ireland	2009		
Italy	2004	2005	2009
Malta	2009		
Netherlands	2004	2009	
Portugal	2002	2005	2009
Slovakia	2009		
Slovenia	2009		
Spain	2009		

Source: http://ec.europa.eu/economy_finance/sgp/index_en.htm

Ireland

In early 2001, Ireland was the first country to be formally warned. Strangely enough, its 2000 budget sported a surplus of 4.7 per cent of GDP and the Commission recognized that its debt level was low. The problem was that its 2001 budget ended up with a surplus of only 1.7 per cent of GDP, while the 2000 Stability Programme had announced a surplus of 4.3 per cent. The year 2001 was an election year and the outgoing government relaxed its virtuous stance. The Irish government and citizens were infuriated and saw the heavy hand of Brussels invading their national sovereignty. The warning was not followed up with any measure.

Germany

The Stability Programme presented by Germany at the end of 2000 anticipated a deficit of 1.5 per cent of GDP for 2001; the final figure was 2.7 per cent of GDP. Following pledges from the German government, ECOFIN decided not to follow the Commission's recommendation of an early warning. But then, contrary to the government's previous promises, the 2002 budget deficit stood at 3.8 per cent of GDP. The German government argued that this was the result of an unforeseeable exceptional event, floods in eastern Germany. This explanation did not cut much ice with the Commission and ECOFIN, and Germany, the promoter of the SGP, became the second country to be put under the EDP in January 2003.

France

For 2001, France had announced a deficit of 1.4 per cent of GDP, but the outcome was 2.7 per cent. In 2002, the deficit reached 3.2 per cent of GDP. The Commission recommended issuing an early warning, which was done by ECOFIN in January 2003. By June 2003, a further deterioration was visible, partly because President Chirac reduced income taxes in both years following an election campaign promise. ECOFIN accepted the Commission recommendation to trigger the EDP.

France and Germany escape the SGP

By November 2003, it had become clear that France and Germany were not heeding the recommendations made earlier by ECOFIN. Their 2003 deficits, not yet known, both turned out to reach 3.7 per cent of GDP, and forecasts for 2004 and 2005 did not envision a return to below 3 per cent. This led the Commission to issue mandatory recommendations, the last step before sanctions. After intense lobbying by France and Germany, ECOFIN decided by qualified majority to 'hold the excessive deficit procedure for France and Germany in abeyance for the time being'. The Court of Justice of the European Communities subsequently annulled this decision, mostly on legal technical grounds.

The Netherlands

In 2003, the Dutch deficit stood at 3.2 per cent, the result of a long slowdown (see Fig. 17.1). As it was expected to fall below 3 per cent in 2004 and afterwards, no action should have been taken. But the Dutch government, which had led the resistance against the French and German whitewash in November 2003 and was keen to restore credibility to the SGP, asked to be put under the EDP.

Implicit liabilities

Another difficult issue is related to the ageing phenomenon. It is currently expected that the share of people aged 65 years and above will rise to 30 per cent of the total population by 2060, up from 17.2 per cent in 2009. This evolution will have profound budgetary implications. Spending on health and retirement is expected to increase very significantly. At the same time, the burden of caring for more elderly people will fall on a smaller proportion of the population. The old-age dependency ratio (the number of those aged 65 and over divided by those of working age (15 to 64 years)) will increase from 25.6 per cent in 2009 to 53.5 per cent in 2060.

These expenditures represent entitlements, sometimes called implicit liabilities. They are true liabilities of the governments because they are enshrined in existing welfare programmes. They are implicit because they appear nowhere in current budgets. They are a source of concern for fiscal discipline because they will eventually increase public expenditures while the corresponding revenues are not provided for. The eventual solution will have to combine a delaying of the age at which people retire, a reduction of pension payments and possibly of health provision, and higher taxes and contributions to the welfare system. Needless to say, each solution is enormously controversial. Some countries have already taken important steps in that direction, others prefer to ignore the issue. The Euro Plus Pact requires that member governments start planning for the ageing phenomenon.

17.5 Summary

The loss of national monetary policy leaves fiscal policy as the only macroeconomic instrument. Budgets can be seen as a substitute for the absence of intra-Eurozone transfers, one of the OCA criteria not satisfied in Europe.

Fiscal policy operates in two ways:

- The automatic stabilizers come into play without any policy action because deficits increase when the economy slows down, and decline or turn into surpluses when growth is rapid.
- Discretionary policy results from willing actions taken by the government.

The main arguments in favour of some collective influence on national fiscal policies are:

- The presence of spillovers, the fact that one country's fiscal policy affects economic conditions in other Eurozone countries. The main spillover channels are: income flows via exports and imports; and the cost of borrowing, as there is a single interest rate.
- The fear that a default by a government on its public debt would hurt the union's credibility.

The theory of fiscal federalism provides arguments for and against the sharing of policy instruments. The presence of spillovers and of increasing returns to scale argues for policy sharing. The existence of national differences in economic conditions and preferences, and of asymmetries of information, argues against policy sharing. The quality of government also matters.

The Stability and Growth Pact (SGP), an application of the excessive deficit procedure (EDP) envisioned in the Maastricht Treaty, is based on four organizing principles:

- A definition of excessive deficits. In principle, deficits should not exceed 3 per cent of GDP. Special circumstances correspond to deep recessions. The 2005 revision allows for a number of 'other factors', a step designed to introduce flexibility.
- A preventive arm, which is designed to encourage governments, through peer pressure, to resist the deficit bias. Prevention rests on annual Stability Programmes. These

programmes are evaluated by the Commission, which issues a recommendation to ECOFIN. ECOFIN, in turn, expresses an opinion.

* A corrective arm, which is triggered when a country is found to have an excessive deficit. This triggers increasingly binding recommendations by ECOFIN, based on suggestions from the Commission. A milder procedure, called early warning, can be triggered when ECOFIN determines, on the basis of a recommendation from the Commission, that a country may soon run an excessive deficit.
* When a country has not followed the recommendations and remains in excessive deficit, sanctions may apply. Sanctions take the form of fines.

The difficulties encountered in the implementation of the SGP can be traced to both economic and political considerations:

* From an economic viewpoint, targeting the annual budget deficit can lead to pro-cyclical policies, i.e. policies that reinforce either a slowdown or a boom. The revised SGP intends to encourage countercyclical policies in good times.
* From a political viewpoint, the SGP faces a formidable contradiction. Fiscal policy is a matter of national sovereignty, in the hands of democratically elected governments and parliaments. At the same time, fiscal policy is recognized as a matter of common concern.

The public debt crisis has shown the danger posed by one country's lack of fiscal discipline. One response is the Euro Plus Pact, which intends to strengthen the SGP. A key feature of the newly proposed pact is the adoption of a reverse voting procedure that would imply that the European Commission's recommendations are automatically accepted unless a super-majority of countries vote against.

Self-assessment questions

1. What is the difference between actual and cyclically adjusted budgets? Why are discretionary actions visible only in changes of the cyclically adjusted budget balance?
2. In Fig. 17.1, identify years when fiscal policy is pro-cyclical, and years when it is countercyclical.
3. What are externalities or spillovers? How do they operate in the case of fiscal policy?
4. Explain the no-bailout clause.
5. What is the intended purpose of the Stability and Growth Pact?
6. How has the Stability and Growth Pact evolved since its inception?
7. When can ECOFIN impose fines in the framework of the Stability and Growth Pact?
8. If the SGP required the cyclically adjusted budget to be balanced every year, explain why fiscal policy would be strictly confined to the automatic stabilizers. What difference would it make if the cyclically adjusted budget had to be balanced on average over business cycles?
9. Why are fines under the Stability and Growth Pact sometimes described as pro-cyclical fiscal policy?
10. Why is there a contradiction between the Stability and Growth Pact and sovereignty in the matter of budgets?

Essay questions

1 How would you reform the Stability and Growth Pact?
2 Does a debt default by a member country make it impossible for this country to remain in the Eurozone?
3 When the Stability and Growth Pact was being negotiated, some countries wanted it to be a fully automatic procedure, others wanted decisions to be interpreted by the Finance Ministers. Why is this distinction important? How does the reverse voting procedure envisioned now change the procedure? Will it work?
4 Some countries argue that the monetary union needs a common fiscal policy to match the common monetary policy. Evaluate this view.
5 With the Stability and Growth Pact and its limits on fiscal policy, what is left for governments to do in the monetary union?
6 As part of its decision on whether to join the Eurozone, the UK Treasury has studied the Stability and Growth Pact and states:

> "*Where debt is low and there is a high degree of long-term fiscal sustainability, the case for adopting a tighter fiscal stance to allow room for governments to use fiscal policy more actively is not convincing. Provided that arrangements are put in place to ensure that discretionary policy is conducted symmetrically, then long-term sustainability would not in any way be put at risk.*"
>
> (Fiscal Stabilization and Eurozone, HM Treasury, May 2003)

Interpret and comment.

Further reading: the aficionado's corner

For a presentation and a defence of the Stability and Growth Pact, see:

Brunila, A., M. Buti and D. Franco (eds) (2001) *The Stability and Growth Pact*, Palgrave, Basingstoke.

For a detailed and critical presentation of the Stability and Growth Pact, see:

Eichengreen, B. and C. Wyplosz (1998) 'The Stability Pact: more than a minor nuisance?', *Economic Policy*, 26: 65–104.

On the tendency of governments not always to serve their citizens' interests and what it means for the EU, see:

Persson, T. and G. Tabellini (2000) *Political Economics*, MIT Press, Cambridge, MA.

Vaubel, R. (1997) 'The constitutional reform of the European Union', *European Economic Review*, 41(3–5): 443–50.

On the role of the SGP during the crisis:

M. Larch, P. van den Noord and L. Jonung (2010) *The Stability and Growth Pact: Lessons from the Great Recession*, European Economy – Economic Papers 429, European Commission.

On ways to reform the Pact:

Wyplosz, C. (2011) 'Fiscal discipline: rules rather than institutions', *National Institute Economic Review* 217, August.

A defence of the Pact, by one of its creators (J. Stark):

Schuknecht, L., P. Moutot, P. Rother and J. Stark (2011) *The Stability and Growth Pact: Crisis and Reform*, Occasional Paper No. 129, European Central Bank.

Fiscal policy

On the cyclical behaviour of fiscal policy, see:

European Commission (2001) 'Fiscal policy and cyclical stabilization in Eurozone', *European Economy*, 3: 57– 80.

Hallerberg, M. and R. Strauch (2002) 'On the cyclicality of public finances in Europe', *Empirica*, 29: 183–207.

Melitz, J. (2000) 'Some cross-country evidence about fiscal policy behaviour and consequences for Eurozone', *European Economy*, 2: 3–21.

For analyses on the politico-economic aspects of fiscal policy, see:

Alesina, A. and R. Perotti (1995) 'The political economy of budget deficits', *IMF Staff Papers*, 42(1): 1–37.

Persson, T., G. Roland and G. Tabellini (2000) 'Comparative politics and public finance', *Journal of Political Economy*, 108(6): 1121– 61.

von Hagen, J. and I.J. Harden (1994) 'National budget processes and fiscal performance', *European Economy Reports and Studies*, 3: 311–408.

For an introduction to the theory of fiscal federalism, see:

Oates, W. (1999) 'An essay in fiscal federalism', *Journal of Economic Literature*, 37(3): 1120–49.

European semester

On reform of the Stability and Growth Pact, see:

The view of the Commission: http://ec.europa.eu/economy_finance/publications/publication_summary7558_en.htm.

The view of the ECB: www.ecb.int/press/key/date/2005/html/sp051013.en.html.

Academic analyses and alternative proposals:

Calmfors, L. (2003) 'Fiscal policy to stabilise the domestic economy in the EMU: What can we learn from monetary policy?', *CESifo Economic Studies*, 49(3): 319–53.

Wolff, G. (2007) 'Budget institutions to counteract fiscal indiscipline in Europe?' Download from www.uni-bonn.de/~guntram/paperspercent5CPittsburghNewsletter022007.pdf.

Useful websites

The official texts can be found on the Commission's website at http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm.

Euractiv's overview of the SGP, with many references, is at www.euractiv.com/Article?tcmuri=tcm:29-133199-16&type=LinksDossier.

References

Burda, M. and C. Wyplosz (2012) *Macroeconomics: A European Test*, 6th edition, Oxford University Press, Oxford.

Eichengreen, B. and Wyplosz, C. (1993) 'Unstable EMS', *Brookings Papers on Economic Activity*, 1: 51–144.

OECD (1997) *Economic Outlook*, OECD, Paris.

Stark, J. (2001) 'Genesis of a pact', in A. Brunila, M. Buti and D. Franco (eds) *The Stability and Growth Pact*, Palgrave, Basingstoke.