

## **Reforming Fiscal Policy Co-ordination under EMU: What Should Become of the Stability and Growth Pact?\***

Since 2002, the Stability and Growth Pact (SGP) has come to be seen as the Achilles heel of EMU. The Pact was originally conceived as a means of ensuring that Member States participating fully in EMU would be disciplined in their fiscal policy, extending the rectitude that these same Member States had to show to meet the Maastricht convergence criteria. Co-ordination of fiscal policy also takes place under the Broad Economic Policy Guidelines (BEPGs), though the interplay between the two facets of fiscal co-ordination has given rise to political difficulties and is poorly understood in public discourse.

The SGP has long been criticized by economists as too simplistic and having too many intrinsic flaws (see, e.g., Eichengreen and Wyplosz, 1998; Buiter, 2003; Buti *et al.*, 2003; Begg and Schelkle, 2004). However, in the first three years of stage 3 of EMU it seemed to work tolerably well, so that it retained political support. Since the beginning of 2002, the SGP has progressively been falling apart, with ever fewer Member States adhering consistently to its rules. Until 2002, Member States managed to keep within the deficit limit of 3 per cent of GDP, but the rule of a medium-term budgetary position ‘close to balance or in surplus’ was not only being generally missed, but was not given much attention. Then, in 2002, Germany and Portugal were deemed to have excessive (over 3 per cent) deficits, and France rapidly followed suit. Under the terms of the SGP, these countries were expected to correct the excessive deficits within a year, and Portugal duly did. However, France and Germany continued to exceed the limit and should therefore have been subject to the next stage of disciplinary action.<sup>1</sup>

When the Commission recommended this course in November 2003, the Council demurred by suspending decisions on whether the next stage of sanctions should be imposed on France and Germany. In response, the Commission elected to take the Council to the European Court of Justice (ECJ) for not

\* This symposium had its genesis in a seminar on the SGP at the London School of Economics and Political Science in March 2004. The editors are grateful to Iain Begg for co-ordinating its production and editing.

<sup>1</sup> Though it should be noted that, contrary to much public comment, they were still two steps (and probably two years) away from the notorious fines under the SGP.

respecting due process. The Court gave its judgment in July 2004 and the Council decision of 25 November 2003 was annulled (ECJ, 2004). Because it had been asked to rule only on procedure rather than on whether France and Germany should be subject to disciplinary action (a matter on which the Court, in its judgment, carefully avoided taking a position), the Court also offered detailed clarification of how the SGP should operate and the respective roles of the two institutions.

Yet although the Court judgment spells out how the SGP should function, the Commission has recognized that it faces the destiny of King Canute and has published a communication on the reform of fiscal co-ordination, noting that 'tensions have accumulated in the application of the SGP, leading to a loss of credibility and ownership and institutional uncertainty' (Commission, 2004a, p. 3). The communication sets out the principles that will underpin a reformed Pact, rather than the detailed provisions, promising full proposals in the coming months. It can reasonably be expected that a reformed SGP will be agreed during 2005.

This symposium examines different facets of EU fiscal policy co-ordination and contributes to the debate on how the SGP should be reformed. The charge-sheet against the current Pact is that its economics were wrong, that it had become politically untenable and that its legal base – despite the ECJ ruling – was crumbling, so that the law had fallen into disrepute. Persevering with criminological metaphors, delinquency had reached the point where copy-cat crime had become the norm and recidivism was likely. However, while there is a degree of consensus on the problems, finding solutions will be harder. In particular, it has to be recalled that the Pact must fit into the legal framework of the Treaty and reflect political realities, with the implication that economists cannot 'assume a tin opener' in proposing changes.

The four contributions to this symposium focus on key dimensions of fiscal policy co-ordination and try to relate these to reform of the SGP. Marco Buti and Lucio Pench note that the breakdown of the Pact's enforcement mechanisms is largely due to lack of compliance by the largest members of the euro area, whilst by and large smaller countries have played by the book. They then explore economic, political economy and institutional explanations for this different fiscal behaviour. Martin Weale widens the debate by relating the co-ordination of fiscal policy and public finance targets to the question of how they impinge on national savings. Henrik Enderlein observes that the original rationale for the SGP has lost much of its salience and suggests that it may now be time to abandon hard rules and return discretion to Member States. Iain Begg and Waltraud Schelkle then focus on the balance between hard and soft law in fiscal policy co-ordination, notably on how to ensure compliance and what happens if Member States flout the rules.

## Why Do Large Countries Flout the Stability Pact? And What Can Be Done About It?\*

MARCO BUTI

Directorate General for Economic and Financial Affairs, European Commission

LUCIO R. PENCH

Directorate General for Economic and Financial Affairs, European Commission

### I. Fiscal Discipline and Stabilization in the Early Years of EMU

The SGP has both a dissuasive and a preventive function: the 3 per cent of GDP reference value should be treated as much as possible as a 'hard ceiling', the breaking of which would put in motion 'a quasi-automatic mechanism' (Stark, 2001) for imposing sanctions, with escape clauses defined as narrowly as possible and legally binding deadlines imposed for taking decisions. This dissuasive arm of the SGP fleshes out the excessive deficit procedure foreseen by the Treaty (Art. 104 TEC). The preventive arm is the 'medium-term budgetary objective of close-to-balance or in surplus' which provides a safety margin of the order of 3 percentage points of GDP against breaching the 3 per cent deficit ceiling, enough to provide for movements in the budgetary balance in response to cyclical fluctuations. It fleshes out the provisions of the Treaty on the surveillance of economic policies. The two arms of the SGP were meant to reinforce the incentives for euro area members to incorporate the 3 per cent of GDP constraint in their *ex ante* budgetary planning, thereby ensuring that short-term stabilization would not enter into conflict with medium-term budgetary discipline.

Lack of progress towards the medium-term objective in the aggregate has been reflected in repeated breaches of the 3 per cent of GDP deficit ceiling by individual Member States. Since 2002 five of the 12 members of the euro area have been subject to the excessive deficit procedure; the early-warning mechanism has been invoked in four cases. Even more damaging to the credibility of the Pact than the frequency of the violations of the ban on excessive deficits has been the perceived disavowal of the original framework, specifically its enforcement mechanism, by key Member States. The crisis of the enforcement mechanism of the Pact became manifest in November 2003 with the *de facto* suspension of the excessive deficit procedures engaged against Germany and France.

\* The opinions expressed in this article are the authors' only and should not be attributed to the European Commission.

The widespread perception of a grave, possibly terminal, crisis of the Pact linked to the breakdown of its enforcement mechanism obscures a more mixed picture emerging from the actual fiscal behaviour induced by its rules. Specifically, recent empirical research on fiscal behaviour under the SGP (see, e.g., Fatás and Mihov, 2003; Gali and Perotti, 2003; IMF, 2004b) suggests:

- an overall improvement in cyclical stabilization, in contrast to the well-documented destabilizing bias of discretionary fiscal policy in the pre-Maastricht era (Buti and Sapir, 1998);
- the SGP has apparently failed to eradicate the underlying – and ultimately unsustainable – deficit bias of fiscal policies. In particular, this bias manifests itself through the continuation of the tendency to run expansionary policies or to fail to consolidate in good times.

In sum, an early assessment of the performance of the Pact indicates that it has delivered a satisfactory degree of fiscal stabilization, but has not lived up to its promise to strengthen fiscal discipline.

The aggregate fiscal performance of the euro area under the Pact, however, encompasses very different outcomes at country level. Specifically, a wide gap has emerged between small and large countries. As a group, and with the notable exceptions of Portugal (and especially Greece), small countries have managed to achieve and maintain an underlying balance of their fiscal positions, while the same goal has proved elusive for large countries.

Suspension of the excessive deficit procedure against Germany and France, potentially signalling the amputation of the dissuasive arm of the Pact, had been preceded by a progressive loss of credibility of the preventive arm, as evidenced by persistent negative gaps between fiscal projections and the outcomes of successive rounds of stability programmes. The three largest countries in the euro area appear largely to blame for the credibility gap affecting stability programmes, as their fiscal projections can be shown to suffer a significant bias to under-predict actual deficits (Strauch *et al.*, 2004; Larch and Salto, 2003).

The rest of the article explores the reasons for the apparent divide between large and small countries' fiscal performance under the Pact. It concludes by outlining possible remedies in the context of ideas for reform of the Pact put forward recently by the European Commission.

## II. Why Do Large Countries Flout the SGP? A Review of the Debate

There has been relatively little debate on why the SGP does not seem to suit large countries. Explanations offered in the literature appeal to economic and institutional/political economy arguments.

A first argument, of traditional Keynesian flavour – emphasized by the ‘French school’ (see, e.g., Fitoussi, 2004; Laurent and Le Cacheux, 2004) – is that the cost of fiscal consolidation tends to be larger in large countries and this would explain their reticence to reduce the deficit towards close-to-balance. As a result, insufficient room for manoeuvre under the 3 per cent deficit ceiling was created, which left large countries exposed in a period of slow-downs. In this interpretation, the lack of consolidation in the period of strong growth in the first years of EMU was not a policy failure, but a ‘regression to the mean’ after years of Maastricht-induced belt tightening (Fitoussi and Saraceno, 2002). More specifically, according to this view, the call simultaneously to pursue budgetary retrenchment and structural reforms by the European Commission and the European Central Bank (ECB) (joined in what has been dubbed the ‘Brussels–Frankfurt consensus’: Sapir *et al.*, 2004) would not suit large economies while it may run in small countries where ‘the best demand policy is supply side policy’.<sup>2</sup> Compared to large, relatively closed economies, smaller, more open economies have a stronger incentive to undertake supply-side reforms rather than pursuing an expansionary fiscal policy, since reforms not only boost potential output directly, but also reduce inflationary pressure which allows them to gain competitiveness and increase external demand.<sup>3</sup>

What is the empirical backing for this argument? According to the European Commission’s Quest model, the short-run impact on GDP of an increase in government expenditure is larger in large countries than in small ones. An increase of 1 percentage point of GDP in public investment or purchases of goods and services adds 0.7 per cent to GDP in Germany, France and Italy, while it varies between 0.5 and 0.6 per cent in the Netherlands, Belgium, Ireland, Portugal and Austria. However, in Finland and Greece (in the latter case also because it is a relatively closed economy for its size) the multipliers are closer to those of the larger countries (Brunila *et al.*, 2002. Results of simulations with the Quest model of various fiscal packages for Germany, Ireland and Greece confirm that the degree of openness matters (Commission, 2002).

While this argument may carry some weight, it neglects the different impact of the behaviour of large countries on the single monetary policy. While

<sup>2</sup> The same type of argument has been put forward by the new President of the EP’s Economic and Monetary Affairs Committee, Pervenche Bérès, in an interview given to *Il Sole 24 Ore* on 9 September 2004.

<sup>3</sup> The incentives to undertake structural reforms increase if the supply-side effects of taxation are taken into account (Buti and van den Noord, 2004) and this may help to explain the greater reform efforts by the smaller countries compared with the big ‘laggards’. Nevertheless, a trade-off between fiscal policy and structural reforms remains, independently of the size of the country. If the domestic ‘political capital’ for unpopular measures is limited, EU authorities face a dilemma on what to recommend to Member States.

large countries may fear the deflationary effects of fiscal retrenchment, they can count much more than small countries on a favourable response by the monetary authorities: the ensuing policy mix at the national level would consist of tighter fiscal and looser monetary policy, a combination that is likely to be beneficial also from a longer-run perspective. For this to happen, however, there is a need for a common move, as each country on its own, even the largest, has a limited influence on the euro area average. Only a common drive towards further fiscal adjustment would create the conditions to allow the ECB to deliver the desirable offsetting monetary response. Arguably, this is one of the rationales for the Stability Pact. As pointed out by Allsopp and Vines (1996, p. 99), 'only if all [countries] act together will the monetary offset to fiscal tightening be likely to eventuate. Thus, participating governments will not only want to commit themselves, they will want to impose commitment on others as well'. Without such common undertaking, the likelihood of an accommodating monetary stance would be reduced.

A second type of argument is that effective fiscal consolidation needs strong growth. Strong growth helps to reduce the budget deficit directly via the working of automatic stabilizers, but also eases structural consolidation to the extent that carrying out restrictive fiscal policies may be easier when the overall cake is growing and it is therefore easier to compensate the losers. Since large countries have grown considerably more slowly than smaller countries, their retrenchment efforts have been hampered (von Hagen, 2002; Fatás *et al.*, 2003). A strong negative correlation can be observed between the size of euro area economies and growth rates: in the period 2001–03, seven euro area members grew more quickly than the average of Germany, France and Italy. Average quarterly GDP growth rates since the beginning of 2001 are 0.1 per cent for Germany and Italy, against 0.5 per cent in the nine smaller countries of the euro area (call this EU-9). In a longer-term perspective, Germany and Italy registered average growth rates of 1.2 per cent and 1.5 per cent over 1996–2003, compared to 3.6 per cent in EU-9 (France: 2.1 per cent).

Clearly, there could be an interplay between the two types of arguments developed above: because of smaller external spillovers, large countries have lower incentives to pursue structural reforms. As a result, the economy tends to run in a lower gear and the country gets locked into a low-growth, high-deficit equilibrium.

However, the experience of Member States is mixed: several fast growing economies have managed to put their house in order, but there are also examples of the opposite. First of all, as recalled above, fiscal misbehaviour often occurred in good times when countries failed to reduce structural deficits by spending the 'automatic' fruits of growth. Second, some decisive fiscal consolidation took place when the country had its back against the wall, so to

speak, and a deep sense of crisis prompted drastic retrenchment. The striking example is Italy at the beginning of the 1990s.

While the above arguments emphasize economic spillovers and the trade-off between fiscal policy and structural reforms, two other arguments of a political economy nature have been put forward to explain the different degree of compliance with EMU's budgetary rules between large and small countries.

De Haan *et al.* (2003) argue that the penalty associated with breaching the SGP rules can be interpreted as a combination of two factors: the pecuniary charge foreseen by the SGP and, possibly more important, the loss of reputation or 'political capital' that ensues from breaching the rules. The latter may reduce the bargaining power of the country in question in negotiations on various other issues at euro area or EU level. They argue that a large country may perceive the penalty for fiscal misbehaviour as low because its size makes the ensuing loss of political reputation negligible. Moreover, given the decision-making in the Council, the likelihood of a large country blocking the procedure is much higher than for smaller countries. Hence, not playing according to the rules of the SGP becomes – in game theoretic terms – a dominant strategy for a large country.

A similar reasoning is put forward by von Hagen (1998) who points out that 'in large countries such as Germany and France, the role of external political constraints such as the admonitions brought by the European Commission is simply too weak to coerce internal politics. This suggests that the effectiveness of outside actors in enforcing budget agreements depends critically on the importance of international organisations in domestic politics, which is plausibly a function of the size of the country' (von Hagen, 1998, p. 35).

Interestingly, de Haan *et al.* (2003) argue that the probability of being sanctioned depends inversely on the number of countries that breach the SGP rules. This could have a herd or contagion effect: 'it is hard to imagine that member states on the verge of breaching the deficit criterion sometime in the not so distant future will take a tough stance with regard to those countries that already have an excessive deficit' (de Haan *et al.*, 2003, p. 20). In addition, as loss of reputation for all is loss of reputation for no one – especially if large countries are already in excessive deficit – Member States that have to take unpopular measures to keep the deficit just below 3 per cent of GDP may decide not to do so.

A fourth explanation for disparities between large and small economies is that a numerical rule such as that embodied in the SGP may have a different effect depending on the quality of domestic budgetary institutions. Hallerberg and von Hagen (1999) and von Hagen (1998) argue that large countries are

usually *delegation* states where the common pool problem is overcome by a strong agenda-setter, typically the finance minister who is *primus inter pares* within the government (with powers to lead the budget process and enforce an overall resource constraint). Instead, most smaller Member States achieve domestic budgetary co-ordination via *commitment*, whereby different parties negotiate a 'fiscal contract' involving strict budgetary targets.

As argued in IMF (2004a), the SGP appears to be less suited to fiscal institutions prevailing in delegation states: '[t]he SGP wraps neatly around the kinds of domestic rules that embody commitment, but the fit with delegation is less smooth. In delegation countries, fiscal policy will be based on domestic considerations and constraints, with few incentives to abide by SGP rules. In commitment states, on the other hand, the SGP reinforces domestic fiscal rules, and can provide an added impetus for all sides to live up to their side of the bargain, especially if the external actor is credible' (IMF, 2004a, p. 92).

Whether size or the quality of domestic institutions matters is, however, open to question. According to the more recent classification of Hallerberg (2004), not all delegation or quasi-delegation countries had problems in respecting the rules of the SGP. For instance, reform of the fiscal institutions in Spain and Austria shifted these countries into the delegation camp as from 2000, and this was not associated with a lower commitment to a tight implementation of the SGP.

Summing up, it is likely that each one of these arguments contains part of the truth. Perception of a larger cost of consolidation, entrenched opposition to structural reforms, together with a lower weight to the external constraints may all have militated against behaviour compatible with the SGP by large euro area members. At the same time, it is widely recognized that large countries – for domestic as well as euro area reasons – need to reduce their structural deficits quickly to reverse the rapid rise in public debt or to accelerate its reduction and pre-empt, at least partly, the impact of ageing populations on public finances.

### III. Can Large Countries Ever be Made to Respect Fiscal Commitments?

The crisis of the Pact has moved the debate on EMU's fiscal framework from the academic to the policy-making arena. The European Commission's proposals (Commission, 2004a), while retaining the anchoring of the fiscal framework to reference values for deficit and debt enshrined in the Treaty, envisage a revised approach to budgetary surveillance. The aim is to improve the economic rationale of the Pact and to emphasize two key objectives of a fiscal framework:

- the short-term cyclical stabilization objective would be enhanced by moving towards an application of the excessive deficit procedure according to a 'conditional' approach, where the *ex ante* fiscal effort would be given greater weight than the *ex post* budgetary outcome in assessing compliance. This should reduce the risk of exacerbating pro-cyclical policies in downturns. Conversely, earlier and more effective enforcement should be put in place to counter pro-cyclicality in upturns;
- the medium-term fiscal discipline objective would be enhanced by applying the excessive deficit procedure not only to the deficit but also to the debt reference value in the Treaty, thereby enforcing a potentially more demanding rule on high-debt countries. Moreover implicit pension liabilities should be factored into the appropriate numerical targets for the 'close-to-balance or in surplus' objective.

How could the revised approach be expected to address the divide between small and large countries? To the extent that the perceived economic rationale of the Pact is enhanced, the chances that it would become self-enforcing at the level of individual countries rather than having to rely on external threats would be increased (Buitier, 2003). This would obviously be an unqualified improvement on the present situation, but one particularly important for ensuring compliance with the framework on the part of the large countries, which are arguably less amenable to external pressure. Moreover, to the extent that the trade-off between short-term stabilization and medium-term discipline is more acute for large countries, these should benefit more from an approach allowing for greater flexibility in the correction of excessive deficits. At the same time, taking more account of debt should increase the pressure on the largest countries in the euro area to adjust, given that they all have debt levels in excess of the 60 per cent treaty reference value (public debt has been increasing rapidly in France and Germany and has remained stuck at very high levels in Italy).

Two other aspects of the Commission's proposal deserve to be mentioned for their possible implications for the large countries' behaviour under a reformed Pact. Both concern institutional arrangements as distinct from substantive rules. One is the proposal that national economic policy cycles be rearranged so that there would be a 'European semester', in which each country would submit to the Council and the Commission an update of its stability programme setting out its medium-term budgetary strategy. This would be followed by a 'national semester', in which national budgets would be prepared, thereby allowing for a more effective incorporation of the results of the multilateral surveillance at European level in national budgetary choices. The other proposal concerns the strengthening of national budgetary institutions and procedures, thereby making operational the Treaty's call on Member States

to 'ensure that national procedures in the budgetary area enable them to meet their obligations'. The proposal would seek to enhance the role of national bodies entrusted with the monitoring of budgetary policies.<sup>4</sup> Besides reflecting a growing consensus among economists on the importance of institutional arrangements for ensuring fiscal stability (von Hagen and Harden, 1994; Wyplosz, 2002; Eichengreen, 2004), the proposal could help to address the special problems large countries face with the EMU fiscal framework, to the extent that they stem from the more self-centred character of the national political debate in which European constraints play a considerably less significant role than in small countries.

A word of caution is, nevertheless, in order. Greater flexibility carries the risk of greater scope for opportunistic behaviour, as state-contingent rules are typically more difficult to verify. The risk is magnified to the extent that the monitoring and enforcement mechanism supporting the rules is open to politically motivated manipulation. In this respect the experience with the implementation of the Pact gives cause for concern. For any reform of the Pact to be credible, Member States, especially the larger ones, need to exhibit greater willingness to subordinate short-term political gains to the long-term common good of protecting the monetary union from the risk of financial unsustainability. A powerful signal in this direction would be for the Member States against which an excessive deficit procedure is being initiated, to agree to abstain from voting at any step of the procedure concerning any Member State.<sup>5</sup> A self-denying ordinance of this kind, especially on the part of the largest Member States, would speak louder than a thousand Council communiqués on the Pact.

*Correspondence:*

Marco Buti and Lucio Pench

Directorate-General for Economic and Financial Affairs

European Commission

200 Rue de la Loi, B-1049 Brussels, Belgium

email: marco.buti@cec.eu.int lucio.pench@cec.eu.int

<sup>4</sup> This would include a role for an independent forecasting authority, to remedy the widespread problem of forecast bias affecting the budgetary process and fiscal performance. The idea is elaborated on in Larch and Jonung (2004).

<sup>5</sup> The Treaty (Art. 104(13) EC) foresees that the votes of the Member State concerned in an excessive deficit procedure should be excluded from the majority required for the decisions subsequent to that on the existence of an excessive deficit. A Member State placed in excessive deficit continues to vote on the procedures concerning other Member States.

## National Saving and the Stability and Growth Pact

MARTIN WEALE

National Institute of Economic and Social Research

### Introduction

The purpose of the Stability and Growth Pact is usually regarded as maintaining fiscal discipline. This is more important in a monetary union of sovereign states than it would be for countries with their own currencies. In a monetary union it is possible that countries will not bear the immediate cost of fiscal laxity themselves. A high rate of government borrowing is likely to lead to a high level of demand and therefore exert some upward pressure on the rate of inflation throughout the monetary union. This, in turn, is likely to require a higher nominal interest rate from the central bank. The rise is likely to be lower than would take place outside a monetary union because the effect of any individual country on union-wide inflation is lower. But since the deficit in each country boosts demand and is therefore likely to be favourable in the short term, the balance of costs and benefits faced by each individual country as a result of its own decisions is changed. Without some sort of fiscal rule there is a risk that every member of the union would run a deficit higher than they would choose outside the monetary union and aggregate welfare would be reduced. This argument is, of course, symmetrical; an excessive surplus will affect all members of the union in a manner opposite to that described above.

This is a short-term concern. In the longer term there is concern about fiscal solvency; this presumably relates more to the stock of debt than to the flow of borrowing. If a government borrows to the point where markets become concerned that government debt will be difficult to service, the risk of default starts to arise. A serious chance of default by a member of a currency union is likely to place financial institutions under suspicion throughout the currency union, with costs for all members. But once again the perceived risk of default is likely to depend on the stock of debt and the associated interest rate burden rather than on the rate of borrowing. It was these two arguments – the short-term inflationary pressure and the long-term risk of default – which led to the Stability and Growth Pact with its essentially arbitrary conditions that countries should aim for budgets close to balance or in surplus in the medium term, and should keep deficits below 3 per cent of GDP in the short term. However, the Commission's recently published proposals for reform (Commission, 2004a) recognize the importance of the stock of debt. They

would allow countries with low public debt to run larger deficits than those with high debt.

However, the underlying analysis assumes that the private sector is structurally well behaved. Excessive private consumption adds to demand and drives up interest rates just as much as excessive public consumption. And excessive borrowing by the private sector may lead to subsequent problems for the public sector in a manner not very different from those arising from cumulative deficits. Arguably, therefore, fiscal concern should focus on the national consumption/saving balance rather than simply borrowing by the public sector.

Nevertheless, both the early and the more recent discussion on the Stability and Growth Pact has focused on finding an effective means of preventing public sector fiscal misbehaviour on the assumption that the private sector is essentially well behaved in the long run. For example Artis and Buti (2002) and Barrell and Dury (2002) discuss appropriate medium targets consistent with a low probability of breaching the rule that the government deficit should not exceed 3 per cent of GDP. They do not air the question whether it is sensible to apply the same 3 per cent limit to all members of the monetary union. HM Treasury (2004) draws attention to the apparently arbitrary nature of the Stability and Growth Pact rules. Buiter (2003) argues that a fiscal rule 'should allow for relevant differences in economic structure and initial conditions'. Buti *et al.* (2003, p. 107) argue for 'a country by country articulation of the medium term budget balance'. While these authors raise the issue of pension liabilities as an important factor, they do not talk about the overall level of national savings as a more important factor. Begg and Schelkle (2004) discuss the importance of a pact which allows 'a coherent mix of policy'; this could be related to the balance between saving and consumption overall, although they do not expand on the matter. The reality is that, in the long run, the sustainability of both the public and private sectors depends on the adequacy of national savings.<sup>6</sup> However, of recent authors only Summers (2004) concerns himself with the level of national savings,<sup>7</sup> expressing the view that the low level of national saving in the United States is its most acute economic problem.

In the short run, high consumption by the private sector will add to inflationary pressure or lead to offsetting action by the central bank just as much as high consumption by the public sector. In the long run, countries which do

<sup>6</sup> Thus the United Kingdom is currently discovering that funding of old age pensions does not automatically deliver these old age pensions. If aggregate saving is low, as it has been in the UK for years, then in the end the taxpayer may be asked to make good the pension promises. But no one would expect the promises to be made good by a high-saving country such as Germany even if the UK had joined the monetary union.

<sup>7</sup> Weale *et al.* (1989) provide a rule-based analysis of an economic policy focused on the macroeconomic targets of price stability and adequate accumulation of national wealth.

not save adequately are likely to face increasing economic difficulties as they fall behind those with more prudent savings habits. Since there is no mechanism for transferring savings from high-saving to low-saving countries, and since it is unlikely that high-saving countries could ever be persuaded to give their savings away, it is more appropriate, even in a monetary union, to consider the adequacy of savings at a national level than at a union-wide level. It is also important to stress that savings adequacy is a long-run rather than a short-run issue; during periods of economic weakness when income is 'lower than normal', it makes sense to allow the savings rate to decline, while when income is temporarily high the savings rate should be expected to rise.

In moving from concern about savings to an assessment of appropriate budgetary targets, attention needs to be paid to the link between the public sector balances and national savings. The relevant identity is:

$$\begin{aligned}\text{National Saving} &= \text{Private Saving} + \text{Public Financial Surplus} \\ &+ \text{Net Public Investment}\end{aligned}$$

This does not guarantee that changes in the public sector financial surplus will impact one for one on national savings. Changes in the public sector financial surplus or in net public investment may have an impact on private savings, so that the effect on national savings is augmented or reduced. We explore the magnitude of this in the next section.

## **I. Net National Savings and Government Financial Borrowing**

OECD statistics provide figures for both government deficits and net national savings which can be scaled to proportions of GDP. We consider data for the EU-15 countries excluding Luxembourg, for the period 1990–2002 (the last year for which they are available). Starting in 1990 has the advantage that we avoid the distortions which might result from the high inflation in the 1980s and its aftermath. We calculate the group mean estimator of the long-run relationship between public sector financial surpluses and national savings (Pesaran and Smith, 1995), finding that in the long run an increase in the public sector financial surplus of 1 per cent of GDP raises national savings by 0.32 per cent of GDP (with a *t*-statistic of 2.18). Obviously further work is necessary to make this relationship more precise.

## **II. Implications for the Stability and Growth Pact**

These results point to the weakness of fiscal targets defined solely in terms of public finances. Provision for the future is achieved not by particular levels of

government borrowing, but by adequate levels of national savings, reflecting private savings habits as well as government decisions.

Since, from the relationship estimated above, a reduction in public borrowing by one point raises national savings by one-third of a point, the implication for fiscal policy is that a country with a shortfall of national savings of  $x$  percentage points should operate a budgetary target  $3x$  points tighter than a country with an adequate level of national savings. Such a rule is only approximate, but it does place fiscal policy in an appropriate context, i.e. its long-term impact on the whole economy. It replaces the arbitrary target of the Stability and Growth Pact with a goal which can be given economic meaning. However, in order to implement the proposal it is necessary to identify an adequate savings level.

While the question of savings adequacy could be addressed from the perspective of the optimal savings literature – that on the optimal path the savings rate is such that consumption can grow at a rate related to the difference between the interest rate and the psychological discount rate (Blanchard and Fisher, 1989, p. 41) – a simpler approach is to focus on the rate of saving needed to keep national wealth as a share of GDP constant. This requirement applies to an economy with a steady rate of growth, if consumption is to grow in line with income. If national wealth is  $w$  times GDP and the trend rate of growth is believed to be  $g$ , then the required rate of saving is  $wg$ . There are a number of possible measures of  $w$ . The broadest includes the value of non-produced capital such as land as well as produced capital, while a more readily available measure is the net stock of produced capital. Logic would point to the use of a broad measure of wealth in assessing the target, but countries with very poor savings records, such as the UK and Portugal, might find it

Table 1: National Saving and Government Financial Surplus: Average Proportion of GDP 1996–2002 (%)

|                        | <i>Austria</i> | <i>Belgium</i> | <i>Germany</i> | <i>Denmark</i> | <i>Spain</i>       | <i>Finland</i>  | <i>France</i> |
|------------------------|----------------|----------------|----------------|----------------|--------------------|-----------------|---------------|
| Average savings rate   | 7.11           | 10.86          | 5.96           | 5.98           | 9.06               | 9.19            | 7.35          |
| Average budget surplus | -1.88          | -0.90          | -2.16          | 1.53           | -1.91              | 2.30            | -2.52         |
|                        | <i>UK</i>      | <i>Greece</i>  | <i>Ireland</i> | <i>Italy</i>   | <i>Netherlands</i> | <i>Portugal</i> | <i>Sweden</i> |
| Average savings rate   | 4.63           | 9.12           | 13.75          | 7.66           | 10.81              | 2.60            | 7.54          |
| Average budget surplus | -0.55          | -2.91          | 1.60           | -2.92          | -0.27              | -3.46           | 1.14          |

*Note:* Countries with savings rates at least one percentage point below a 7.5% point target are shown in italic.

easier to adjust to the framework based around the ratio of net produced capital to GDP. This ratio is typically close to three, although it is lower in the United Kingdom which has a long history of low saving and which now feels short of some forms of public sector capital. If we take a ratio of three and also assume a long-run growth rate of 2.5 per cent per annum, this points to a net savings target of 7.5 per cent of GDP. It would, however, be desirable to adapt the savings target to the different growth circumstances of different countries by articulating their individual savings needs more fully.

The luxury of hindsight makes it possible to explore how the interaction between budgetary targets and national savings might have worked in practice. In Table 1 we show the mean budget surplus as a proportion of GDP over the period 1996–2002 and also the average savings ratio.

The table shows that there are four countries with savings shortfalls of more than 1 per cent of GDP. Using the rule of thumb that a 1 per cent of GDP budget deficit reduces the rate of national savings by one-third of 1 per cent of GDP, we can see that a balanced budget would have been expected to bring Germany to within one percentage point of the target. Denmark shows a substantial savings shortfall even though it has run a budget surplus; it would be wrong to conclude that its budgetary position should be relaxed merely because of the surplus shown. For the UK to deliver of savings rate of within one percentage point of the target would require a budget surplus of around 5 per cent of GDP. Whatever the feasibility of such a figure, it is clear that the UK is not in a position to adopt a fiscal position more lax than that of other countries; its low level of public debt proves a misleading indicator. Portugal's position is even worse.

Of the countries which are exceeding the savings target, Ireland is no doubt aspiring to a growth rate faster than the 2.5 per cent per annum used to derive the target savings rate of 7.5 per cent and can justify higher saving on this basis. The other savings surplus countries might, following the rule of thumb, be allowed (or even 'expected', if excessive saving is seen as damaging to output, bringing us back to the question of the EU – or euro area – aggregate) to run deficits on a sustained basis as a means of reducing their overall savings rate. But it has to be stressed that more sophisticated savings targets should ideally be calculated taking into account the effects of population ageing, and need to be reassessed from time to time as private savings behaviour changes. What we have done here is to highlight countries with serious and obvious savings shortfalls. In the short term these add to demand and (with the exception of the UK which is outside the euro area) impose higher interest rates on everyone in the euro area in exactly the same way as public sector deficits can. In the long term they raise the risk of fiscal insolvency because

failure to save enough is likely to result in fiscal burdens which countries may find difficult to meet.

The existing Stability and Growth Pact could be amended to focus on budgetary targets which reflect national savings differences without fundamental changes to its nature as a co-ordination mechanism. It would be necessary to agree on budgetary targets in the light of past levels of national savings and hold these for, say, a five-year period. At the end of the five years they would be reviewed in the light of the more recent evidence on the relation between savings and the budget surplus. But within the five-year period, the savings-based targets would replace the goal of 'close to balance or in surplus' and the existing co-ordination mechanism (Buti and Sapir, 1998) would be applied around these new targets.

The recent Commission proposals (Commission, 2004a) suggest that, within the general framework of the Stability and Growth Pact, countries' fiscal deficits should be assessed with respect to their overall public debt. But some of the reasons for objecting to excessive deficits – the short-term prospect of increased inflationary pressure and the long-term risk of economic difficulties – also apply to countries whose private sectors do not save adequately and whose national savings are therefore low. Thus it would be desirable to take into account private saving habits at least as much as the stock of public debt when setting fiscal targets around which to apply the co-ordination mechanisms of the Stability and Growth Pact.

*Correspondence:*

Martin Weale

National Institute of Economic and Social Research

2 Dean Trench Street, London SW1P 3HE, England

email: mweale@niesr.ac.uk

## Break it, Don't Fix it!

HENRIK ENDERLEIN

Freie Universität Berlin

### Introduction

The conduct of domestic fiscal policies in a monetary union is subject to two largely opposite requirements. On the one hand, member countries need to be given some autonomy to undertake stabilizing fiscal measures in the domestic economy. On the other hand, member countries' fiscal autonomy needs to be reduced if there is a credible risk that a country seeks free-riding on overall systemic stability. The first six years of EMU clearly show that the latter requirement (which is the basis of the Stability and Growth Pact) should be given much less emphasis, while the former should be the starting point of any debate on the appropriate conduct of fiscal policies in EMU.

### I. Why Domestic Stabilization Matters Most

One of the key lessons of the first six years of EMU is the primacy of the pro-cyclical real interest rate effect over the counter-cyclical real exchange rate effect. In a monetary union, if inflation rates vary across countries, the single nominal interest rate as set by the ECB will translate into country-specific real interest rates. Member States with higher inflation will face lower real interest rates, whereas Member States with lower inflation rates will face higher real interest rates. The real interest rate effect thus operates in a pro-cyclical manner. However, the inflation rate also affects the real exchange rate, and thus exports and imports to other euro area countries. High-inflation countries will face reduced external demand, whereas low-inflation countries will improve their competitiveness. The real exchange rate effect thus operates in a counter-cyclical manner. Several analyses of the first years of EMU now indicate that the real interest rate effect outweighs the real exchange rate effect (for an overview see IMF, 2004c).

As the ECB does not take into account economic developments in individual Member States but rather targets the euro area as a whole,<sup>8</sup> its 'one-

<sup>8</sup> In one of its first public statements, the ECB notes: 'The Governing Council of the ECB makes it clear that it will base its decisions on monetary, economic and financial developments in the euro area as a whole. The single monetary policy will adopt a euro area-wide perspective; it will not react to specific regional or national developments' (ECB press release, 13 October 1998).

size-fits-all' monetary policy tends to destabilize those domestic cycles whose economic fundamentals are not in line with the euro area average (see Enderlein, 2004, for a more detailed analysis of this issue). Member States with higher inflation rates than the euro area average face low real interest rates generating higher rates of investment and consumption. These effects drive up the domestic growth rate beyond its long-term potential, thereby generating even higher inflation rates, further reducing real interest rates, and ultimately generating cyclical overshooting and price booms. Similarly, in a context of low inflation and high real interest rates, growth rates are likely to fall below potential growth, thus triggering even higher real interest rates and potentially generating a textbook bust cycle.

It is often claimed that domestic prices across EMU (and thus also real interest rates) are bound to converge, given the mobility of goods and services in the internal market. It is argued that self-reinforcing cyclical phenomena will be stopped by a decline (or boom) in exports, caused by the real appreciation (depreciation) of the exchange rate. Proponents of that approach, however, seem to put too much emphasis on price flexibility and factor mobility. A significant share of domestic output derives from so-called 'spatially fixed factors', such as real estate and heavy machinery, which are not affected by direct price competition (MacLennan *et al.*, 1999). Moreover, as analyses of the much more integrated US states indicate, regional economic adjustments based on real exchange differentials take a significant amount of time (around four years, see Arnold and Kool, 2002), thus indicating that adjustment within the EU might take even longer. So there are good theoretical reasons to believe that regional and cyclical divergences within the EU will not be self-correcting, but rather require some stabilizing measures through fiscal policy.

This theoretical argument is confirmed in practice. As the past six years have shown, the relevant economic fundamentals in most euro area economies have diverged from the euro area average. Looking at cross-country differences in the two crucial elements for the conduct of monetary policy – the inflation rate and the output gap – it becomes quite clear that persistent patterns of inflation and output gap differentials have developed. Member States such as Ireland, the Netherlands and Spain have experienced significantly higher inflation rates than the euro area average and have grown above potential.<sup>9</sup> Germany, on the other hand, has had the lowest inflation and highest real interest rates, while remaining far below its potential growth rate. Overall, there is an intriguing positive relationship with a fit of roughly 0.5

<sup>9</sup> The Dutch economy, which is one of the most open in EMU, now seems to face stronger real exchange rate effects than real interest rate effects (see IMF, 2004b, p. 109).

between average deviations from euro area inflation and average deviations from the euro area output gap in the first years of EMU.<sup>10</sup>

In a monetary union, central banking is an ineffective instrument to counter these trends. On the contrary, instead of stabilizing cyclical over-reactions, the common monetary policy involuntarily contributes to their emergence and persistence. It is important to note, however, that blaming the ECB for that outcome would not be fair. From the perspective of the euro area as a whole, the ECB has run a fully appropriate monetary policy over the past six years. Taylor-rule calculations based on euro area average data clearly support that proposition (Surico, 2003). Looking at each Member State individually, however, there are indications that the impact has been suboptimal (IMF, 2004b; see also Deroose *et al.*, 2004). These developments are a cause for concern. It is not just a theoretical extreme case to imagine two equally sized groups of countries in EMU – one with relatively high and the other with relatively low rates of inflation – and the ECB targeting a neutral medium rate, thus destabilizing both groups and contributing to their further shifting apart.

Against this background, the role of fiscal policies in EMU should be re-interpreted. The decision on fiscal stances should put more focus on offsetting the potentially destabilizing consequences of the ECB's monetary policy.

## II. Why Hard Rules at the European Level are Likely to Fail

The use of fiscal policy as a stabilizing instrument (see also Buti and Pench in this issue) in the domestic economy raises two questions related firstly, to the effectiveness of fiscal policy as a stabilizing instrument and, secondly, the political feasibility of fiscal stabilization. It is interesting to note that these two issues are often treated as one: fiscal stabilization is considered ineffective because its political implementation seems impossible.

Concerning the effectiveness of fiscal stabilization, there is more and more evidence that fiscal policy can act as effectively as monetary policy in stabilizing the domestic economic cycle – under the condition that it is appropriately implemented (Blanchard and Perotti, 2002; Calmfors, 2003; see also HM Treasury, 2003, for an overview). The focus of this literature is mainly on automatic stabilizers and expresses doubts on the feasibility of discretionary spending. However, some authors even claim that the desired effects of fiscal stabilization could be enhanced through well-conducted discretionary measures (for example via capital income taxation, VAT, payroll taxes: Calmfors,

<sup>10</sup> The precise value of  $r^2$  depends on the method of calculation and the time period (see Deroose *et al.*, 2004, p. 10, as an example).

2003). There are thus good reasons to believe that the issue of whether or not to allow fiscal stabilization in EMU is not an issue of technical effectiveness, but rather an issue of political feasibility.

The question is, how to achieve domestically stabilizing fiscal policies without creating a collective action problem based on free-riding deficit-spending by member countries' governments. This question is of an institutional nature and involves important choices on five main features:

1. Rule *v.* discretion: Are decisions on Member States' fiscal stances assessed on objective grounds (as the original SGP foresaw in theory) or subjective considerations, negotiations and peer pressure (as the original SGP turned out to function in practice)?
2. Stick *v.* carrot: Is the framework based on rewards (as in Casella's proposal on 'tradable deficit permits': Casella, 1999) or on sanctions (as the original SGP)?
3. Centralized *v.* pooled: Are assessments and decisions related to fiscal stances taken by a central authority that does not involve national governments (e.g. the Commission or an independent Stability Council), or do national governments assess and decide amongst themselves (e.g. in the Eurogroup or Ecofin)?
4. Negative *v.* positive: Do common guidelines or rules set negatively formulated limits to fiscal stances (i.e. the SGP approach: 'you are not allowed to run deficits above 3 per cent') or do they give positively formulated indications to be followed (i.e. the BEPG approach: 'in 2004 you should reach a budgetary deficit of 1 per cent').
5. Symmetric *v.* asymmetric: Do guidelines apply to both deficits and surpluses or do they apply only to deficits?

Feature (1) relates to the crucial elements of credibility and enforceability. Features (2) and (3) involve basic institutional choices. From the perspective of this article, however, features (4) and (5) are the most tricky.

Indeed, the main problem with any common rule at the European level is that it has to be either *negative* and *asymmetric* or *positive* and *symmetric*. It is impossible to devise a rule that limits Member States' fiscal room for manoeuvre on the surplus side without being prescriptive (setting a surplus limit would make no sense). In other words, the choice is between preserving the asymmetric SGP and making the BEPGs binding.

Neither of these two options appears satisfactory given the need for domestic stabilization. In a framework of negative and asymmetric rules (the SGP approach), countries with high inflation (and thus low real interest rates) can free-ride on low inflation rates in low growth countries by limiting their efforts to cool down the domestic economy. The discussion on Ireland's lack

of domestic fiscal stabilization in 1999–2000 nicely illustrates that point. Proposals to harden the SGP framework (Berger *et al.*, forthcoming) might cure the symptoms of the recent institutional difficulties, yet they do not tackle the underlying collective action problem in a negative and asymmetric framework.

On the other hand, making positive and symmetric rules binding (i.e. a ‘hardened’ BEPG approach) would face a considerable problem of democratic legitimacy, and sanctions may, in any case, be incapable of being effective, as discussed by Begg and Schelkle in this issue. Decisions on national fiscal stances, their financing, and their inter-temporal implications (i.e. inter-generational distribution) are at the very core of government’s prerogatives and should only in very extreme cases be separated from direct electoral choice. Proposals to straitjacket fiscal reaction functions fully within a rigid institutional framework (Fatás and Mihov, forthcoming; Wyplosz, 2002) might seduce political economists, yet their implementation at the European level would probably create more new problems than it would solve current ones (voters might remember the aphorism ‘no taxation without representation’).<sup>11</sup>

To solve the current problem, there are two corner solutions and a set of intermediate options. Not surprisingly, the present proposals by the Commission are clustered around the set of intermediate options. They amount to amending the SGP by changing one or several of the aforementioned basic institutional features.

It is unlikely however, that this approach can succeed. In particular, as outlined above, it will prove difficult to bridge the gap between a negative but asymmetric and a symmetric but positive framework. Moreover, the choice between ‘rules’ and ‘discretion’ is unlikely to be taken in a clear manner. A sentence in the Commission communication highlights the dilemma: ‘It would be essential to secure a proper balance between the potentially *higher degree of discretion* in the surveillance and co-ordination of fiscal policies and the need for keeping the *rules-based framework* simple and transparent’ (Commission, 2004a, p. 3, emphasis added).

The first corner solution would be a radical shift to a full-fledged system of fiscal federalism. The EU budget or some redistributive mechanism would ensure that surplus money from the fastest growing Member States were used to compensate low inflation and low growth countries. This solution might have some appeal but it looks unrealistic at the present juncture (could one imagine Ireland wiring money to Germany?).

The second corner solution would be to abolish the SGP and to use the soft framework of the BEPGs more effectively. This second solution raises the

<sup>11</sup> If Member States decided to bind themselves within their national frameworks, the issue would look different (see below).

question of whether the euro area would be much worse off in a framework without sanctions and enforcement, i.e. without a rule-based approach to fiscal discipline. Curiously, this question is rarely asked.<sup>12</sup>

### III. Why a Soft Framework Might Work Better

What could such a solution look like? The present Article 104 on the excessive deficit procedure would have to be amended, as well as the secondary legislation on the SGP. In principle, both sets of instruments could be scrapped. As changes to the present SGP framework now look likely and would in any case require unanimous agreement in the Council, taking the more radical steps on Article 104 and the SGP appears only slightly more cumbersome from an institutional and legal viewpoint (assuming that there was widespread support).

Article 99 on the BEPGs would remain in place. Its soft provisions, based on the clause that 'Member States shall treat their economic policies as a matter of common concern', would shift to the centre of fiscal policy co-ordination in EMU. The BEPGs would continue to set out requirements on the appropriate conduct of fiscal policies (and other areas of economic policy-making) to the Member States. Yet Member States would ultimately retain full autonomy to go against the recommendations of the BEPGs. Article 99 contains no provisions on sanctions or enforcement. The framework would rely fully on peer and public pressure.

Ecofin would remain the most important body for undertaking peer review on the basis of independently prepared assessments by the Commission. It might be worth strengthening the Commission's role in the procedure by transforming its 'recommendation' on the BEPGs into 'proposals' (Commission proposals can ultimately only be amended by a unanimous vote in the Council, whereas Commission recommendations can be amended by a qualified majority). Threats to euro area price stability, arising from excessive deficits in single Member States, would have to be tackled by the ECB, as required by the Treaty. Ensuing negative consequences for the Member States would have to be dealt with in Ecofin or the Eurogroup. Peer pressure would have to work. The ECB should refuse any kind of negotiated policy mix.

The only real test case for such a framework would be a sovereign default of one of the euro area Member States. Such a default could trigger systemic instability in the euro area and/or require an inflationary bail-out by the ECB (see Eichengreen and Wyplosz, 1998 for a detailed assessment). This

<sup>12</sup> Pisani-Ferry (2002, p. 2) notes: 'Among economists and policymakers, there is not much disagreement, neither on the risk an irresponsible fiscal behaviour would create for monetary union, nor on the need for common rules or mechanisms that ensure fiscal discipline'.

scenario is possible, but arguably rather unlikely. Would voters really tolerate constantly deteriorating public finances? There surely are countries in which this was the case (think of Argentina), yet the question remains whether any early warning and sanction mechanism would be more effective in preventing fiscal defaults than the risk of the fiscal default itself. Moreover, it should be recalled that the ECB is not allowed to purchase government debt directly from Member States.

The main benefit of abolishing the SGP would be to return full political ownership of fiscal decisions to Member States. As explained above, decisions on deficits and surpluses are of a fundamentally political nature and involve important issues of inter-temporal redistribution. EU institutions should be allowed to issue recommendations on Member States' public finances and encouraged to defend these in public discourse. However, Member States should be allowed to disagree, giving national politics the last word in the procedure.

Should single Member States be willing to submit themselves to any kind of technocratic guidance, they could still decide to establish such rules and frameworks at the national level. Belgium, for example, has delegated significant power over its fiscal stance to the *Conseil Supérieur des Finances* (Hallerberg *et al.*, 2001). Indeed, should Member States recognize that their fiscal institutions do not allow them to stabilize their domestic economy successfully by using a combination of automatic stabilizers and discretionary measures, they could reform national institutions (see Enderlein, 2004, for an overview of examples) or ultimately fully bind themselves (as recommended by Wyplosz, 2002).

Experiences in the US and Canada support that approach. Neither of the two countries has established a rule-based deficit control mechanism for states and provinces, although some US states and Canadian provinces have balanced budget rules. Both federal systems trust market forces to adjust borrowing costs, and there are no recent examples of state or provincial government default in either of the two countries. It is true that several states and provinces are accumulating excessive debts yet, as the recent example of California shows, voters may ultimately favour fiscal restraint over the risk of debt default.

## Conclusion

When the SGP was initially discussed in 1996, the focus was almost exclusively on the need to prevent fiscal free-riding in EMU. No government soft on deficits should be allowed to free-ride on the solid policies of its peers. To put it more bluntly: in the view of many (and particularly German officials

keen to reflect public opinion), the SGP was a tool to solve the problem of specific candidates for EMU accession, in particular Italy (Dyson and Featherstone, 1996, pp. 532–3). It was designed for a specific purpose, just as functionalist arguments of institutional choice predicted. Eight years down the road, this underlying *problematique* of the SGP has lost most of its salience. The SGP now looks like a classic example of how an institution can miss its target, generate unintended consequences, and even result in negative consequences for its initial sponsor.

EMU has manifestly created largely unexpected problems of domestic fiscal stabilization. Adjustments via the real exchange rate operate much less effectively than initially predicted. Against this background, a debate on the appropriate conduct of fiscal policies in EMU should start with a focus on the domestic level. The question must be raised whether EMU would not just be better off without any binding fiscal rules.

It is quite unlikely that any rule-based framework at the European level would succeed in establishing the right incentive structure to cope simultaneously with domestic stabilization and the avoidance of fiscal free-riding. Instead of trying to square the circle, the responsible actors in EMU might be better off by scrapping the SGP and using the more flexible framework of the BEPGs instead. This approach might look radical in its formal implications; in practice, however, it could function more effectively than a badly reformed SGP.

*Correspondence:*

Henrik Enderlein

John F. Kennedy Institut

Freie Universität Berlin

Lansstrasse 7–9, 14195 Berlin, Germany

email: mail@henrik-enderlein.de

## Can Fiscal Policy Co-ordination be Made to Work Effectively?

IAIN BEGG

London School of Economics and Political Science

WALTRAUD SCHEKLE

London School of Economics and Political Science

Fiscal policy co-ordination under EMU has a number of goals that are not necessarily mutually consistent. It currently relies on a mix of hard rules, backed by sanctions, and 'soft law' arrangements to achieve them. A first goal is to avoid fiscal laxity that might induce inflationary pressures and lead the ECB to impose tighter monetary policy. Second, there is the aim of fiscal sustainability, defined in the SGP as keeping the general government current budgetary deficit below 3 per cent of GDP, while aiming for a position 'close to balance or in surplus' over the medium term. A third goal, stabilization, is only implicit by allowing governments to run deficits *up to* 3 per cent, with the margin between 3 per cent and 'close to balance' considered sufficient to allow automatic stabilizers to function effectively (Artis and Buti, 2000, 2002). The collective stabilization effort as it manifests itself in the aggregate fiscal balance of the euro area is not explicitly co-ordinated, but derives from the separate national decisions on deficits.

Should different methods of co-ordination be favoured to advance the different aims of fiscal co-ordination? The two regulations (1466/97 and 1467/97) that constitute the SGP combine soft and hard methods of co-ordination aimed at preventing problems (through surveillance) and disciplining euro area members that transgress, while the requirement for co-ordination under the BEPGs is set out in Article 99 TEC. Soft co-ordination relies on governments taking the lead, drawing up national stabilization (or convergence) programmes that are subject to benchmarking, surveillance and review by their peers in the Ecofin Council. Hard co-ordination is embodied in the excessive deficit procedure, with provisions for escalating sanctions, culminating in a fine, to make governments comply.

These arrangements constitute a potentially contradictory mix insofar as the soft co-ordination procedures under the BEPGs can be flexibly interpreted and do not contain enforcement mechanisms, whereas even the soft law elements of the excessive deficit procedure (especially after the ECJ ruling of 10 July 2004) constitute a legally enforceable process in which discretion is

curtailed.<sup>13</sup> Can this mix be improved upon and made more effective? We will first consider which co-ordination method should be applied to achieve the three goals of fiscal policy co-ordination mentioned above. In contrast to present arrangements, we find an *a priori* case for budget consolidation to be co-ordinated softly, while stabilization, both to support monetary stability and to dampen EMU business cycles, calls for hard co-ordination. Then we analyse the flaws in the present system and suggest a way forward by applying political means to achieve the economic end of effective fiscal policy.

## I. Effective Co-ordination: The Soft Law Approach

The problems that have arisen in implementing these co-ordination mechanisms have been well documented (see, *inter alia*, Eichengreen, 2004; Louis, 2004; Buti *et al.*, 2003; Begg and Schelkle, 2004; Berger *et al.*, forthcoming). Now, the dilemma for economic governance is how to make this mix of hard and soft law effective. In particular, can a variant on the 'open method of co-ordination' (OMC) provide a sufficiently robust way forward?<sup>14</sup> The OMC literature points to a number of criteria for preferring soft co-ordination:

1. The *specific contents* of a policy render it unsuitable for EU interference and harmonization, precluding hard co-ordination, especially where agreement requires the explicit consent of parliament, or policy is not easily codified by law. Examples are redistribution, education and cultural policy, all closely connected with national identity, but macroeconomic stabilization can also be considered nationally sensitive (Hodson and Maher, 2001, pp. 721–2, 729; Chalmers and Lodge, 2003, pp. 1–3).
2. The *operation* of the policy does not require hard co-ordination. Instruments to implement a policy may be so diverse and/or complex that there is a disproportionate cost to harmonization. Moreover, diversity and subsidiarity may be compatible with achieving compatible outcomes that avoid negative spillovers, as well as allowing for policy learning that enhances each other's effectiveness. Retaining flexibility and legitimacy outweighs the gains from centralization, functional segmentation and vertical integration (De la Porte *et al.*, 2001, p. 5; Chalmers and Lodge, 2003, pp. 3–4; Trubek and Mosher, 2003, pp. 50–2).

<sup>13</sup> For a fuller analysis, see Maher (2004, p. 11) who concludes 'that soft law is not merely a matter of politics; and that even where there is no immediate sanction other than peer pressure and the prospect of further decisions soft law has practical and legal effects that cannot be bypassed'.

<sup>14</sup> Strictly the BEPGs, because they are Treaty based, are not an open method of co-ordination, but they manifestly rely on the range of 'soft' procedures (peer-review, etc.) which characterize OMC.

3. The policy is *in the process of change* and thus difficult to co-ordinate tightly. If co-ordination is meant to support policy reforms, national needs and priorities, as well as the uncertainty surrounding any reform must be respected. A consensus or shared policy belief may have to be developed first. Apart from learning, co-ordination of reforms can then help to reframe the domestic discourse and shift the distribution of power over the domestic agenda, provided it remains of an ostensibly technical and 'depoliticized' nature (Dyson, 2000, pp. 5, 68–76; De la Porte *et al.*, 2001, p. 7; Hodson and Maher, 2001, pp. 723, 730; Schelkle 2004, pp. 156–7).

The argument as regards the first set of criteria risks being circular: because fiscal policy is not tightly integrated, its contents appear 'sensitive'. Yet, for most of the post-war era, conducting monetary policy was the ultimate economic symbol of national sovereignty. Euro area members, however, have manifestly retained their sense of nationhood. It thus seems to us that the contents of fiscal policy – anti-inflationary device, sound finance of public services, income stabilization – do not point to an *a priori* case for either hard or soft co-ordination.

Turning to the second set of criteria, from a purely economic perspective, fiscal policy has to be seen at two levels. Decisions on taxes, redistributive policies and the provision of public goods involve sensitive normative choices. In contrast, stabilization of inflationary pressures or recessions is, by definition, concerned only with the balance of spending and taxation. As such, it ought to lend itself readily to hard rules, with the implication that the case for soft co-ordination is weak. However, stabilization programmes are never as simple as raising or lowering taxes and spending across the board by 5 per cent, but about expanding and reducing specific programmes or taxes with inevitable redistributive and allocative consequences. Yet the case for tight co-ordination is strengthened if we take into account the political economy of fiscal stabilization in a heterogeneous union. Small open economies may free-ride on other members, while the bigger members can take this asymmetric burden-sharing as a pretext to care only for their national stability. *A priori*, fiscal stabilization calls for more robust sanctions and incentives than peer review. On the other hand, diversity and subsidiarity is compatible with, or even required for, achieving budget consolidation. Decision-makers are accountable to their constituencies and subject to the constraints of mandates conferred on them by their national parliaments, with the implication that there have to be country-specific ways of achieving policy goals.

On the third set of criteria, budget consolidation again seems to be a candidate for soft co-ordination because it is central to the ambitious Lisbon reform agenda. An implicit assumption is that sustainable public finances in

Europe require structural reforms of the welfare state, to keep expenditure for pensions, health and unemployment within manageable limits. The imperatives of learning, experimentation and the potential leverage in domestic politics make reforms related to budget consolidation a prime candidate for soft co-ordination. By contrast, stabilization is only indirectly and inadvertently affected by these reforms. The operation of automatic stabilizers is less in need of reform since a number of recent studies have shown that they are operating effectively (e.g. Buti *et al.*, 2002). However, welfare state reforms may, ironically, weaken the impact of automatic stabilizers.<sup>15</sup>

In sum, we find a strong *a priori* case for co-ordinating efforts at national budget consolidation by a soft method, such as the BEPGs, rather than the SGP. Stabilization, both to make life easier for the ECB and to have in place an effective counter-cyclical policy for EMU as a whole is, however, a candidate for fairly tight co-ordination, even though it is soft at present.

## II. Compliance and Enforcement

Implementation of fiscal policy co-ordination raises tricky problems about how any reformed SGP can be made to work more effectively. The principal questions concern the balance between hard law and explicit sanctions, on the one hand, and soft law and political processes on the other. In the September 2004 Commission communication (Commission, 2004a), proposals on improving enforcement call for Member States to take on ownership of the Pact and to improve their national budgetary institutions. But the communication notes wryly (Commission, 2004a, p. 8) that 'enforcement in the context of the Treaty remains in the hands of Member States and their political commitment to exert fully the adequate peer pressure'.

What are the gaps and flaws in the system? One is that sustainable public finances are not adequately defined (Bini-Smaghi, 2004). What constitutes a sustainable level of debt is far from clear (for a review, see the box in Commission, 2004b, pp. 111–12; see also Collignon and Mundschenk, 1999). Relevant issues concern the actual and expected (or desired) ratios, and the factors that shape both the growth rate of GDP (the denominator of the ratio) and the dynamics of public expenditure and taxation (the balance of which determines the numerator). For example, if a short-term deficit leads to higher growth prospects, its impact on sustainability may actually be positive, despite the immediate adverse effect on public finance indicators. It is this sort

<sup>15</sup> Their stabilizing properties, however, depend to a considerable extent on the sheer size of public finances (Fatás and Mihov, 1999). This implies, ironically, that if EMU member states succeed in budget consolidation by downsizing government, they may need to step up discretionary stabilization in order to compensate the weakening of the automatic stabilizers.

of effect that underlies the 'golden-rule' approach, adopted by the UK, in which public investment is seen as likely to boost growth potential. Some structural policies that may also have negative short-term effects on public finance indicators may, similarly, affect future demand for public expenditure, even though they cannot be regarded as public investment. The obvious example is recalibration of the pensions system which may entail short-term outlays to buy out existing commitments, but yields longer-term benefits for public finances by reducing the projected share of pension expenditure in GDP.

A second flaw, broadly acknowledged in much of the debate on reform, is that the crude indicators (3 per cent, close to balance...) are unhelpful. Eichengreen (2004, p. 4) believes that any numerology is ultimately flawed and suggests instead that euro area members should be assessed on whether they have put in place the right policies in relation to underlying factors shaping fiscal (in)discipline, such as unfunded pensions liabilities or susceptibility to soft budget constraints in the public sector. He argues that a reformed pact 'should focus not merely on fiscal numbers, which are arbitrary and easily cooked, but on fiscal institutions', and calls for the development of an index of institutional reform.<sup>16</sup>

Another flaw is that there is no obvious means of penalizing a Member State that flouts the medium-term 'close to balance' rule, yet it is this rule (however it might be amended) that is the defining one for policy co-ordination. Perhaps the most intractable problem, however, is the disrepute into which the system has fallen. Now, not only is there a history of non-compliance, but governments that might otherwise have been willing to commit themselves risk opprobrium from their supporters if they are seen to bow to the strictures of a discredited system. The Commission proposals and, indeed, most of the alternatives discussed in this symposium and elsewhere all rely on a degree of compliance that, on the track record of the SGP, cannot be taken for granted. The challenge then is how to move forward, raising a number of awkward questions.

- First, how can the analysis of policy be improved so as to identify better when there is a problem? For Eichengreen (2004), the assessment of institutional conditions should be conducted by an independent agency and the results used to determine whether the Member State should then be classed as fiscally sound or suspect, with the latter group obliged to conform to numerical rules as at present. Better identification of problems would, as Eichengreen argues, lend greater legitimacy to a reformed pact. However, while his scheme might be expected to avoid

<sup>16</sup> Recent revelations about under-recording of the Greek budget deficit in the run-up to euro area accession reinforce the point about cooking the books.

inappropriate identification of countries as being in breach of sound fiscal policies, thereby reducing the frequency with which the excessive deficit procedure is used, it still leaves open the question of how to deal with Member States who flout the rules.

- Second, can fiscal co-ordination be reformed so as to forestall overly frequent resort to disciplinary procedures while retaining the underlying commitments? The answer must start from customizing targets, rather than having 'one-size-fits-all'. We suggest, too, that the focus should be on an economically robust interpretation of the sustainability of public finances (see also Coeuré and Pisani-Ferry, 2003).
- Third, can discipline be achieved and, if so, how? Any explicit financial penalty is probably doomed to fail. Certainly, the idea that a euro area finance minister would authorize a payment of up to 0.5 per cent of GNI if the last stage of the excessive deficit procedure had been reached is fantasy. But even much smaller financial penalties (be they the deposit envisaged in the penultimate stage of the excessive deficit procedure or withholding of payments due to the Member State from the Community budget) would provoke a severe political crisis. Moreover, most of the Member States currently in the dock are net contributors to the EU budget who would have the credible option of retaliating by suspending 'their' fourth resource payments to 'Brussels'. Even net recipients always have the credible threat of blocking EU business in an 'empty chair' protest.

### III. Which Way Forward?

For us, the nub of the fiscal co-ordination problem is how political commitment to conform can be boosted and made binding, failing which we would be tempted to go along with Enderlein's view (in this issue) that we might as well eschew fiscal co-ordination. The Commission's new proposals imply a significant shift in emphasis from *ex post* disciplinary action to *ex ante* prevention of deficits. But what can be done if a Member State simply refuses to comply? Three principal options can be envisaged. The first, even if it has been found wanting so far, is to have progressively more onerous sanctions rooted in hard law. The second is to put the emphasis almost exclusively on preventive measures, while the third is to rely on a political process.

*Hard sanctions*, to be credible, must almost by definition culminate in the Member State being confronted by some pecuniary loss. Whether it is a deposit being converted into a fine (as in the SGP at present) or the withdrawal of EU payments to the Member State (such as from the CAP or the structural funds, as some commentators have proposed), it seems inconceivable for the

reasons discussed above that a Member State would ever acquiesce. It is, consequently, difficult to believe that such hard sanctions could ever be truly enforceable.

*Prevention* is already explicit in the provisions for multilateral surveillance. The Commission proposals would, potentially, strengthen the intensity and the procedural efficiency of these monitoring processes. To that extent, the proposals would be expected to contribute to a lessening of the frequency with which deficits became excessive, the more so as the recasting of the definitions of excessive deficits means that economically questionable cases would arise less often.<sup>17</sup> But if prevention is the principal constraint, it is only if markets punish delinquency that governments would be penalized for ignoring the recommendations addressed to them. Moreover, governments would need to be wholly convinced of the quality of the analysis (and, indeed, of the data used) behind the surveillance.

What could make sense in this regard is a signalling system (Begg and Schelkle, 2004) in which the monitoring agency has very clear and transparent thresholds that allow it to flag an emerging problem and to grade its severity. Once a country receives a rating (those from Moody's or S&P for the bond markets are a good parallel) not just for its creditworthiness, but explicitly also for its conduct of policy, the markets would be expected to respond. One-size-fits-all thresholds would not, however, be tenable; instead, a reformed system would need to have customized targets and thresholds on a range of indicators.

*An effective political process* would take time to evolve, but would have the greater merit of mixing prevention with a degree of political flexibility, possibly adding political sanctions. There will always be a trade-off between commitment and flexibility, and for any process to be effective it plainly also has to be seen to be legitimate. Hence the challenge is to devise a system capable of reconciling these potentially conflicting aims, a conjuring trick that will not be easy to pull off. As Buti and Pench note, 'ownership' – however inelegant the term – is crucial: it is the Member States, after all, that determine fiscal policy, but if they do not endorse the rules they are asked to abide by, it is inevitable that they will renege when the going gets tough. Policy-setting also has to have a suitable forum in which to operate and here too there is arguably a gap insofar as the only discussions on collective fiscal policy take place behind closed doors in the Economic and Financial Committee and the Eurogroup. There are no open commitments, other than *inter pares* among finance ministers and their officials, and consequently little op-

<sup>17</sup> Allsopp and Artis (2003, p. 27) also observe that 'a better set of arrangements should be credibility enhancing'.

portunity for public discourse on the decisions and commitments made. In such a system, it is hardly surprising that Member States tend to backslide.

How then could a more effective political process be developed and can any reform of fiscal policy co-ordination function convincingly without it? We argue that there are four requirements:

1. There has to be a supranational body in which policy is formulated in a transparent manner. For this task, a more open Eurogroup is the obvious candidate.
2. There should be clear parameters for each Member State's fiscal policy against which its record can be judged.
3. There need to be channels through which national finance ministers can be held to account when they make (or break) such commitments.
4. While stopping short of financial sanctions for the reasons put forward above, there should be a political price to pay for Member States that breach agreed policies without good, economically defensible, reasons.

As Louis (2004) explains, the Eurogroup will be 'institutionalised' by the Constitutional Treaty, but only in a protocol so that, although its status will be boosted, it will remain an informal body that lacks the authority to make decisions. In his view the compromise on the status of the Eurogroup – though perhaps politically all that could be envisaged – leaves it in a curious limbo: 'no legal decision can be taken within the Eurogroup, transparency is not in the picture, and commitments are without any possible sanction, apart from lack of credibility in the eyes of colleagues' (Louis, 2004, p. 586). We regard this as an opportunity lost.

To address the second point, we advocate a form of fiscal sustainability plan for each Member State that is negotiated with an external body such as the Commission (but which could be an independent agency). This might encompass savings targets, as recommended by Weale in this issue, but what is essential is that it should be accepted by the Member State and adequately scrutinized domestically, and strategic in character. Thus, rather than having recommendations parachuted in from above, as with the BEPGs, the strategy would be one for which the Member State is unambiguously responsible.

But whether it is through the Eurogroup or some other body, the key both to holding finance ministers to account and, should the circumstances arise, blaming and shaming them will be transparency. A scorecard approach has been adopted for the Lisbon strategy and other common commitments, but has lacked visibility. We propose an elaboration of the Eichengreen index that goes beyond the technical indicators of fiscal policy to embrace specific commitments. In that way, national parliaments and the media can quickly ascertain when a Member State is breaking its promises. Explicit political

sanctions at the EU level, such as losing the right to vote on euro matters in Ecofin, might help to reinforce these commitments, but the main sanction should be expected from the perception of failure in domestic politics.

*Correspondence:*

Iain Begg and Waltraud Schelkle

European Institute

London School of Economics and Political Science

Houghton Street, London WC2A 2AE, England

email: iain.begg@lse.ac.uk

w.schelkle@lse.ac.uk

## References

- Allsopp, C. and Artis, M.J. (2003) 'The Assessment: EMU, Four Years On'. *Oxford Review of Economic Policy*, Vol. 19. No. 1, pp. 1–29.
- Allsopp, C. and Vines, D. (1996) 'Fiscal Policy in EMU'. *National Institute Economic Review*, No. 158, pp. 91–107.
- Arnold, I. and Kool, C. (2002) 'The Role of Inflation Differentials in Regional Adjustment: Evidence from the United States'. Mimeo. Available at «[http://www.fdebw.unimaas.nl/algec/staff/framespages/kool/emf/paperpercent20arnold\\_kool.pdf](http://www.fdebw.unimaas.nl/algec/staff/framespages/kool/emf/paperpercent20arnold_kool.pdf)».
- Artis, M.J. and Buti, M. (2000) '“Close to Balance or in Surplus”: A Policy-maker's Guide to the Implementation of the Stability and Growth Pact'. *Journal of Common Market Studies*, Vol. 38, No. 4, pp. 563–91.
- Artis, M.J. and Buti, M. (2001) 'Setting Medium-term Fiscal Targets in EMU'. In Brunila, A., Buti, M. and Franco, D. (eds).
- Barrell, R. and Dury, K. (2001) 'Will the SGP ever be Breached?'. In Brunila, A., Buti, M. and Franco, D. (eds).
- Begg, I. and Schelkle, W. (2004) 'The Pact is Dead: Long Live the Pact'. *National Institute Economic Review*. No. 189, pp 86–98.
- Berger, H., de Haan, J. and Jansen, D.-J. 'Why Did the Stability and Growth Pact Fail?'. *International Finance* (forthcoming).
- Bini Smaghi, L. (2004) 'What Went Wrong with the Stability and Growth Pact?'. Paper prepared for the conference on 'Monetary Union in Europe: Historical Perspectives and Prospects for the Future', Copenhagen, December.
- Blanchard, O.J. and Fischer, S. (1989) *Lectures on Macro-Economics* (Cambridge, MA: MIT Press).
- Blanchard, O.J. and Perotti, R. (2002) 'An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output'. *Quarterly Journal of Economics*, Vol. 117, No. 4, pp. 1329–68.
- Brunila, A., Buti, M. and Franco, D. (eds) (2001) *The Stability and Growth Pact* (Basingstoke: Palgrave).
- Brunila, A., Buti, M. and in't Veld, J. (2002) 'Fiscal Policy in Europe: How Effective Are Automatic Stabilizers?'. *Empirica*, No. 30, pp. 1–24.

- Buiter, W.H. (2003) 'Ten Commandments for a Fiscal Rule in the E(M)U'. *Oxford Review of Economic Policy*, Vol. 19, No. 1, pp. 84–99.
- Buti, M. and Sapir, A. (eds) (1998) *Economic Policy in EMU – A Study by the European Commission Services* (Oxford: Oxford University Press).
- Buti, M. and van den Noord, P. (2004) 'Fiscal Policy in EMU: Rules, Discretion and Political Incentives'. *Moneda y Crédito*, No. 218, pp. 265–307.
- Buti, M.S., Eijffinger, S. and Franco, D. (2003) 'Revisiting EMU's Stability Pact: A Pragmatic Way Forward'. *Oxford Review of Economic Policy*. Vol. 19. pp. 100–11.
- Buti, M., Martinez-Mongay, C., Sekkat, K. and van den Noord, P. (2002) 'Automatic Stabilizers and Market Flexibility in EMU: Is there a Trade-off?'. Economics Department Working Paper No. 335 (Paris: OECD). Available at «[www.oecd.org/eco](http://www.oecd.org/eco)».
- Calmfors, L. (2003) 'Fiscal Policy to Stabilize the Domestic Economy in the EMU: What Can We Learn from Monetary Policy?'. *CESifo Economic Studies*, Vol. 49, No. 3, pp. 319–53.
- Casella, A. (1999) 'Tradable Deficit Permits: Efficient Implementation of the Stability Pact in the European Monetary Union'. National Bureau of Economic Research Working Paper, No. 7278.
- Chalmers, D. and Lodge, M. (2003) 'The Open Method of Co-ordination and the European Welfare State'. CARR Working Paper No. 11 (London: Centre for Analysis of Risk and Regulation, London School of Economic and Political Science).
- Coeur, B. and Pisani-Ferry, J. (2003) 'A Sustainability Pact for the Eurozone'. Unpublished paper, available at «<http://www.pisani-ferry.net/base/re-03-keynes-sustainability.pdf>».
- Collignon, S. and Mundschenk, S. (1999) 'The Sustainability of Public Debt in Europe'. *Economia Internazionale*, Vol. 52, No. 1, pp. 101–59.
- Commission of the European Communities (2001) *Public Finances in EMU – 2001*, European Economy, Reports and Studies, No. 3.
- Commission of the European Communities (2002) *Public Finances in EMU – 2002*, European Economy, Reports and Studies, No. 3.
- Commission of the European Communities (2003) *Public Finances in EMU – 2003*, European Economy, Reports and Studies, No. 3.
- Commission of the European Communities (2004a) 'Strengthening Economic Governance and Clarifying the Implementation of the Stability and Growth Pact'. COM(2004) 581.
- Commission of the European Communities (2004b) 'Public Finances in EMU 2004'. *European Economy*, 3/2004.
- De Haan, J., Berger, H. and Jansen, D.-J. (2003) 'The End of the Stability and Growth Pact?'. CES Ifo Working Paper, No. 1093.
- De la Porte, C., Pochet, P. and Room, G. (2001) 'Social Benchmarking, Policy Making and New Governance in the EU'. *Journal of European Social Policy*, No. 11, pp. 291–307.

- Deroose, S., Langedijk, S. and Roeger, W. (2004) 'Reviewing Adjustment Dynamics in EMU: From Overheating to Overcooling'. European Commission Economic Paper No. 198.
- Dyson, K. (2000) *The Politics of the Euro-Zone: Stability or Breakdown?* (Oxford: Oxford University Press).
- Eichengreen, B. (2004) 'Institutions for Fiscal Stability'. *CESifo Economic Studies* Vol. 50, No. 1, pp. 1–25.
- Eichengreen, B. and Wyplosz, C. (1998) 'The Stability Pact: More than a Minor Nuisance?'. *Economic Policy*, Vol. 13, No. 26, pp. 65–115.
- Enderlein, H. (2004) *Wirtschaftspolitik in der Währungsunion* (Frankfurt am Main: Campus).
- European Court of Justice (2004) 'Commission of the European Communities v. Council of the European Union (C-27/04)'. Judgment released on 13 July
- Fatás, A. and Mihov, I. (1999) 'Government Size and Automatic Stabilizers: International and Intranational Evidence'. CEPR Discussion Paper No. 2259 (London: Centre for Economic Policy Research).
- Fatás, A. and Mihov, I. (2003) 'On Constraining Fiscal Policy Discretion in EMU'. *Oxford Review of Economic Policy*, Vol. 19, No. 1, pp. 112–31.
- Fatás, A. and Mihov, I. 'The Case for Restricting Fiscal Policy Discretion'. *Quarterly Journal of Economics* (forthcoming).
- Fatás, A., von Hagen, J., Hughes Hallett, A., Strauch, R.R. and Sibert, A. (2003) *Stability and Growth in Europe: Towards a Better Pact*. CEPR Monitoring European Integration, No. 13 (London: CEPR)
- Fitoussi, J.-P. (2004) 'Small Is Beautiful?'. *Le Monde*, 24 August.
- Fitoussi, J.-P. and Saraceno, F. (2002) 'A Theory of Social Custom of Which Soft Growth May Be One Consequence. Tales of the European Stability Pact'. Documents de Travail de l'OFCE, pp. 2002–7.
- Fitoussi, J.-P. and Saraceno, F. (2004) 'The Brussels–Frankfurt–Washington Consensus: Old and New Tradeoffs in Economics'. Observatoire Français des Conjonctures Economiques, mimeo.
- Gali, J. and Perotti, R. (2003) 'Fiscal Policy and Monetary Integration in Europe'. *Economic Policy*, No. 37, pp. 533–72.
- Hallerberg, M. (2004) 'The Treaty of Maastricht and the Making of Budgets in Europe 1973–2002'. University of Pittsburgh, mimeo.
- Hallerberg, M. and von Hagen, J. (1999) 'Electoral Institutions, Cabinet Negotiations, and Budget Deficits within the European Union'. In Poterba, J. and von Hagen, J. (eds) *Fiscal Institutions and Fiscal Performance* (Chicago: University of Chicago Press).
- Hallerberg, M., Strauch, R. and von Hagen, J. (2001) 'The Use and Effectiveness of Budgetary Rules and Norms in EU Member States'. Report Prepared for the Dutch Ministry of Finance by the Institute of European Integration Studies in Bonn. Available at <[http://www.minfin.nl/default.asp?CMS\\_TCP=tcpAsset&id=837FBACF757B4875B8C20969955C6EB7](http://www.minfin.nl/default.asp?CMS_TCP=tcpAsset&id=837FBACF757B4875B8C20969955C6EB7)>.

- HM Treasury (2003) *Fiscal Stabilization and EMU*. HM Treasury Discussion Paper, available at [«http://www.hm-treasury.gov.uk/documents/the\\_euro/assessment/studies/euro\\_assess03\\_studherefordshire.cfm»](http://www.hm-treasury.gov.uk/documents/the_euro/assessment/studies/euro_assess03_studherefordshire.cfm).
- HM Treasury (2004) 'The Stability and Growth Pact: A Discussion Paper' (Norwich: HMSO).
- Hodson, D. and Maher, I. (2001) 'The Open Method as a New Mode of Governance: The Case of Soft Economic Policy Co-ordination'. *Journal of Common Market Studies*, Vol. 39, No. 4, pp. 719–46.
- IMF (2004a) *Euro Area, Article IV Report*, Washington, July.
- IMF (2004b) 'Has Fiscal Behavior Changed Under the European Economic and Monetary Union?'. *World Economic Outlook*, September, pp. 103–36.
- Larch, M. and Jonung, L. (2004) 'Improving Fiscal Policy in the EU: The Case for Independent Forecasts'. *Economic Papers* No. 210 (Brussels: CEC).
- Larch, M. and Salto, M. (2003) 'Fiscal Rules, Inertia and Discretionary Fiscal Policy'. *Economic Papers* No. 194 (Brussels: CEC).
- Laurent, E. and Le Cacheux, J. (2004) 'L'Europe Boucles d'Or: Trois Maximes pour Sortir d'une Impasse'. *Lettre de l'OFCE*, No. 246.
- Louis, J.-V. (2004) 'The Economic and Monetary Union: Law and Institutions'. *Common Market Law Review*, No. 41, pp. 575–608.
- MacLennan, D., Muelbauer, J. and Stephens, M. (1999) 'Asymmetries in Housing and Financial Market Institutions and EMU'. CEPR Discussion Paper No. 2062.
- Maher, I. (2004) 'Economic Policy Co-ordination and the European Court: Excessive Deficits and ECOFIN Discretion'. *European Law Review*, Vol. 29, No. 6.
- Pesaran, M.H. and Smith, R.P. (1995) 'Estimating Long-run Relationships from Dynamic Heterogeneous Panels'. *Journal of Econometrics*, Vol. 68, pp. 79–113.
- Pisani-Ferry, J. (2002) *Fiscal Discipline and Policy Coordination in the Eurozone: Assessment and Proposals*. Note for the GEA meeting of 16 April, Brussels: European Commission. Available at [«http://www.europa.eu.int/comm/dgs/policy\\_advisers/experts\\_groups/gea/gea\\_2002\\_04/pisani-ferry.pdf»](http://www.europa.eu.int/comm/dgs/policy_advisers/experts_groups/gea/gea_2002_04/pisani-ferry.pdf).
- Sapir, A. et al. (2004) *An Agenda for a Growing Europe* (Oxford: Oxford University Press).
- Schelkle, W. (2004) 'Understanding New Forms of European Integration: A Study in Competing Political Economy Explanations'. Forthcoming in Jones, E. and Verdun, A. (eds) *Political Economy Approaches to the Study of European Integration* (London: Routledge).
- Stark, J. (2001) 'Genesis of a Pact'. In Brunila, A., Buti, M. and Franco, D. (eds).
- Strauch, R., Hallerberg, M. and von Hagen, J. (2004) 'Budgetary Forecasts in Europe. The Track Record of Stability and Convergence Programmes'. ECB Working Paper Series, p. 307.
- Summers, L.H. (2004) 'The United States and the Global Adjustment Process'. Institute for International Economics. Available at [«http://www.iie.com/publications/papers/summers0304.htm»](http://www.iie.com/publications/papers/summers0304.htm).
- Surico, P. (2003) 'Asymmetric Reaction Functions for the Euro Area'. *Oxford Review of Economic Policy*, Vol. 19, No. 1, pp. 44–57.

- Trubek, D.M. and Mosher, J.S. (2003) 'New Governance, Employment Policy, and the European Social Model'. In Zeitlin, J. and Trubek, J.M. (eds) *Governing Work and Welfare in the New Economy* (Oxford: Oxford University Press).
- Von Hagen, J. (1998) 'Budgeting Institutions for Aggregate Fiscal Discipline'. Centre for European Integration Studies, University of Bonn. Mimeo, February.
- Von Hagen, J. (2002) 'More Growth for Stability – Reflections on Fiscal Policy in Euroland'. ZEI Policy Paper, June.
- Von Hagen, J. and Harden, I. (1994) *National Budget Processes and Fiscal Performance*, European Economy, Reports and Studies, No. 3, pp. 311–418.
- Weale, M., Blake, A.P., Christodoulakis, N., Meade, J.E. and Vines, D.A. (1989) *Macro-economic Policy: Inflation, Wealth and the Exchange Rate* (London: Unwin Hyman).
- Wyplosz, C. (2002) *Fiscal Policy: Rules or Institutions?*. Paper prepared for the Group of Economic Analysis of the European Commission, April.