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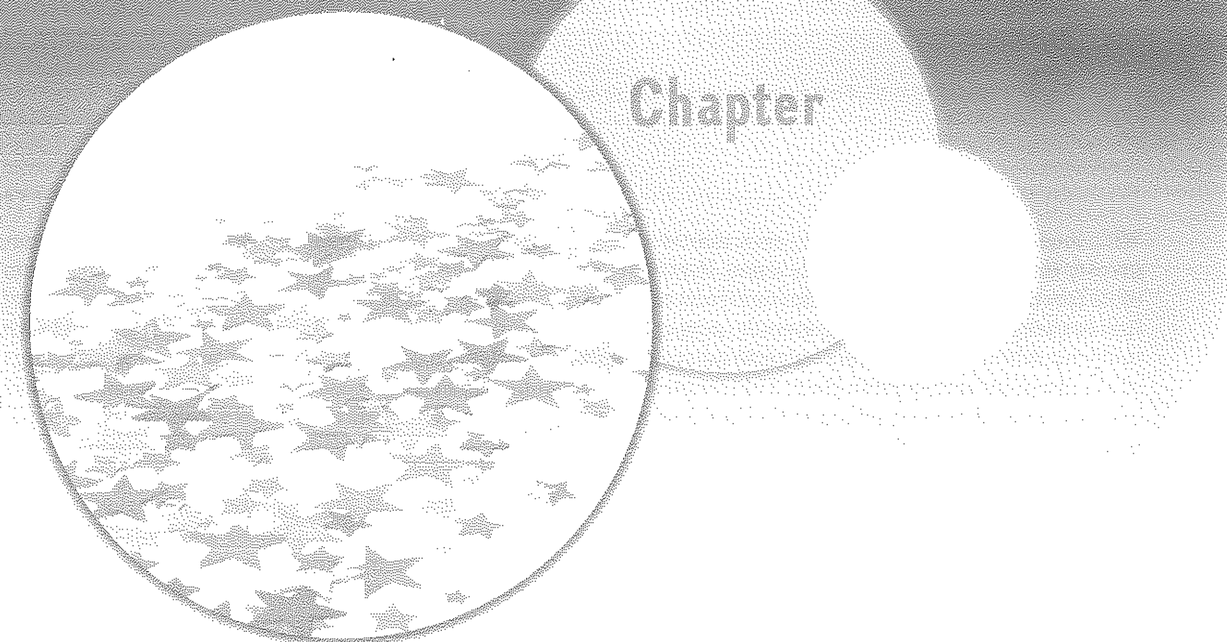

I know very well that the Stability Pact is stupid, like all decisions which are rigid.

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

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

Conclusions of European Council, 24–25 March 2011

Fiscal policy and the Stability Pact

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Introduction

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

17.1 Fiscal policy in the monetary union

17.1.1 An ever more important instrument?

When joining a monetary union a country gives up one of its two macroeconomic instruments – monetary policy – but retains full control of the other – fiscal policy. Without national monetary policy, fiscal policy is the only instrument remaining with which to deal with asymmetric shocks when they arise. From this perspective, fiscal policy becomes more important for smoothing national output and employment fluctuations and, through the impact of prices, inflation too. As seen in Chapter 13, in a rigidly fixed exchange rate regime like the monetary union, the *MP* schedule is irrelevant given the loss of monetary autonomy, but the *IS* schedule can be shifted with fiscal policy.

Unfortunately, fiscal policy is unlikely to be a good substitute for monetary policy. It is a very different instrument, more difficult to activate and less reliable than monetary policy. Importantly, it can be misused, and is often misused when governments ignore the need to eventually balance their budgets.

Indeed, changes in public spending and/or taxes impact on the budget balance, which immediately raises the question of the financing of public debt. Consider, for instance, a cut in income taxes designed to increase private spending. A tax cut creates a budget deficit. The government will have to borrow and thus increase the public debt, but how will this new debt be reimbursed? If, as is plausible, taxes are eventually raised, the policy action is properly seen as the combination of a tax reduction today and a tax increase later. This is an action unlikely to boost private consumption once taxpayers realize that the benefit today will be offset by an equivalent cost in the future.[1]

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

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

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

17.1.2 Borrowing instead of transfers

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

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

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

17.1.3 Automatic stabilizers and discretionary policy actions

Automatic stabilizers

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

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

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

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

Source: Economic Outlook, OECD, 1997

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

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

Discretionary fiscal policy

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

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

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

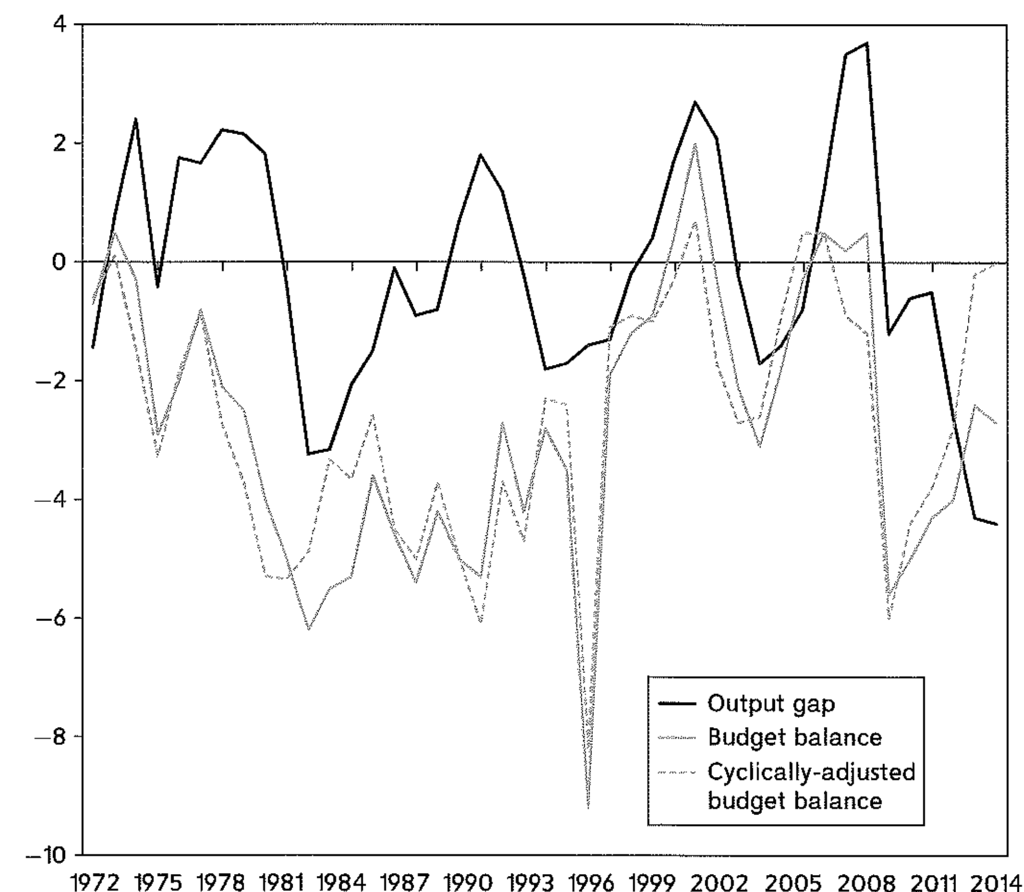
Box 17.1 The automatic stabilizers at work in the Netherlands

Figure 17.1 displays the output gap along with the actual and cyclically-adjusted budget balance of the Netherlands. We can see that the actual balance generally moves in tandem with the output gap, an indication that the automatic stabilizers are at work. Note also the steady improvement in the budget that occurred during the convergence years 1995–99. This occurred partly as a result of government efforts to meet the Maastricht entry conditions, as shown by the reduction of the cyclically-adjusted deficit, and partly because a rising output gap made it easier to meet those conditions. It is also interesting to observe that the sharp deterioration in the budget over 2001–05 – which caused the Netherlands to violate the Stability and Growth Pact – is the consequence of a serious slowdown, and occurred in spite of visible government efforts to avoid this outcome. The financial crisis that began in 2007 then caused the Dutch economy to contract sharply. Both actual and cyclically-adjusted balances in parallel developed large deficits, an indication that little discrete action occurred. The government then moved sharply to close the cyclically-adjusted balance, which had contributed to a dramatic fall in output. With the economy in a deep recession, the actual budget modestly improved.

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

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

Figure 17.1 Actual and cyclically-adjusted budgets in the Netherlands, 1972–2014



Note: All variables are measured as a percentage of GDP.

Source: Economic Outlook, OECD

17.2 Fiscal policy externalities

17.2.1 Spillovers: a case for policy coordination

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

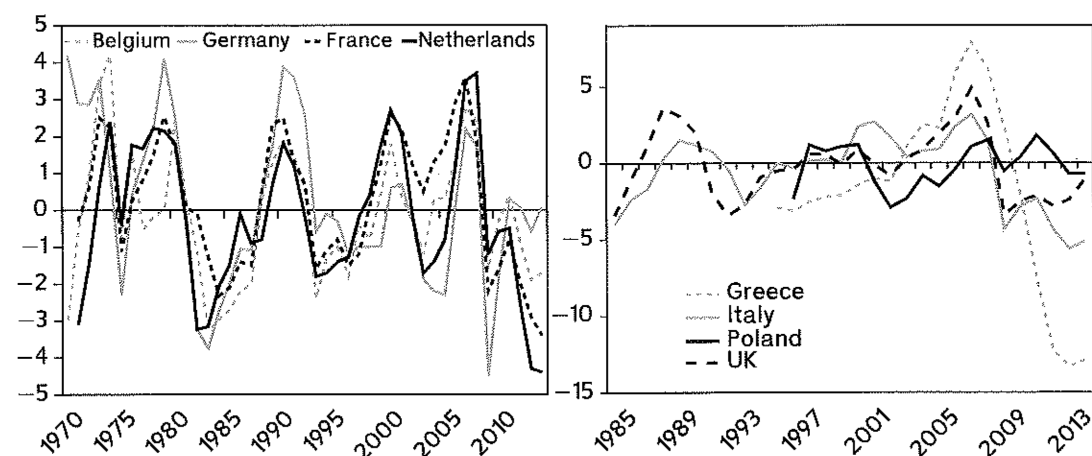
While, formally, fiscal policy remains a national prerogative, it is natural to ask whether the deepening economic integration among Eurozone countries calls for some degree of coordination. On the one hand, the setting up of a monetary union strengthens the case for fiscal policy coordination as it promotes deeper

ties. On the other hand, fiscal policy coordination requires binding agreements defining who does what and when. Such detailed arrangements would limit each country's sovereignty, precisely at a time when the fiscal policy instrument assumes greater importance. The question is whether sharing the same currency increases the spillovers to the point where some new limits on sovereignty are desirable and justified. To answer this highly controversial question, we review the channels through which spillovers occur and examine what difference the Eurozone makes.

17.2.2 Cyclical income spillovers

Business cycles are transmitted through exports and imports. When Germany enters an expansion phase, for instance, it imports more from its partner countries. For these partner countries, the German expansion means more exports and more incomes. This is how the expansion tends to be transmitted across borders. Figure 17.2 displays output gaps for a number of countries. The countries in the left-hand chart are all Eurozone members and have been EU members since the Treaty of Rome; their business cycles are highly synchronized, and were so long before the adoption of the euro. Those exhibited in the right-hand chart are more recent partners and two of them have not adopted the euro. Their cycles are much less synchronized. Quite obviously, the spillover is stronger the more the countries trade with each other, and sharing the same currency enhances income spillovers. This observation is a reminder of the endogenous OCA hypothesis presented in Chapter 15. A high degree of synchronization means fewer asymmetric shocks.

Figure 17.2 Income spillovers, 1970–2014



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

Source: Economic Outlook, OECD

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

What all these examples have in common is that there is ample room for mutually beneficial cooperation. This conclusion is a particular case of the general result of Section 17.2.1.

17.2.3 Borrowing cost spillovers

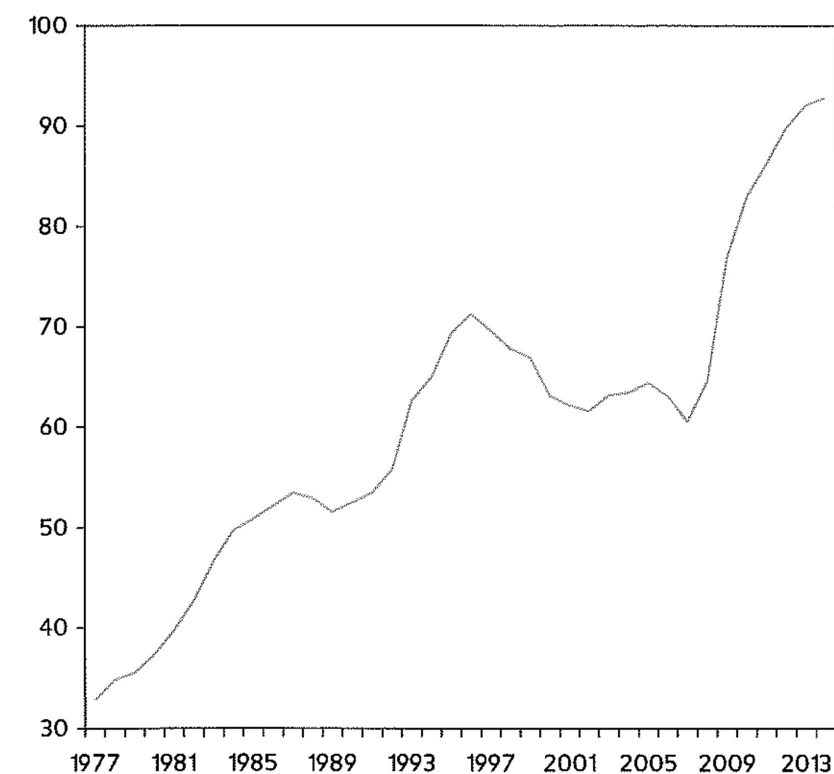
A fiscal expansion increases public borrowing or reduces public saving. As the government is usually the country's biggest borrower, large budget deficits may push interest rates up. Once they share the same currency, Eurozone member countries share the same interest rate. One country's deficits, especially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

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

17.2.4 Excessive deficits and the no-bailout clause

Even before the crisis, it was clear that debt sustainability could not be taken for granted in Europe. As Figure 17.3 shows, overall public indebtedness (as a percentage of GDP) in the Eurozone had more than doubled between 1977 and 1996, just before the check on admission criteria.[6] In the distant past, public debt

Figure 17.3 The Eurozone's public debt (% of GDP), 1977–2014



Source: AMECO, European Commission

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

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

had occasionally risen but only in difficult situations, mostly during wars. The post-war build-up of debt, partly related to the oil shocks of the 1970s and 1980s, illustrates what is sometimes called the 'deficit bias'. This bias reflects a disquieting tendency for governments to run budget deficits for no other reason than political expediency. Does it call for a specific collective measure?

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

Second, heavy public borrowing by one country is a sign of fiscal indiscipline that could trouble the international financial markets. If markets believe that one country's public debt is unsustainable, they could view the whole Eurozone with suspicion. The result would be sizeable capital outflows and euro weakness. This is precisely what happened in 2010–11 within the Eurozone.

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

A further fear is that the mere threat of one member country's default would so concern all other member governments that they would feel obliged to bail out the nearly bankrupt government. This last risk has been clearly identified in the Maastricht Treaty, which included a 'no-bailout' clause. Article 125 of the European Treaty forbids all public institutions, including governments, to provide direct support to a Eurozone government. Article 123 does the same regarding the ECB. Yet it always was an open question whether, in the midst of an emergency, some arrangement could still be found to bail out a near-bankrupt government. For example, the ECB could be 'informally' pressed to relax its monetary policy to make general credit more abundant at a lower cost, which would result in inflation. More generally, it was feared that a sovereign default would badly affect the Eurozone and undermine its credibility. We will see in Chapter 19 that the no-bailout clause was ignored in May 2010.

17.2.5 The deficit bias and collective discipline

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

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

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

Table 17.2 Public debt within Europe (% of GDP), 2014

Austria 80.3	Belgium 101.7	Bulgaria 23.1	Croatia 69.0	Cyprus 122.2	Czech Rep. 44.4
Denmark 43.5	Estonia 9.8	Finland 59.9	France 95.6	Germany 76.0	Greece 177.2
Hungary 80.3	Ireland 121.0	Italy 135.2	Latvia 39.5	Lithuania 41.8	Luxembourg 23.4
Malta 72.5	Netherlands 73.8	Poland 49.2	Portugal 126.7	Romania 39.9	Slovakia 56.3
Slovenia 80.4	Spain 100.2	Sweden 41.6	United Kingdom 91.8	EU 89.5	Eurozone 96.0

Source: AMECO, European Commission

17.3 Principles

The existence of spillovers is one argument for sharing policy responsibilities among independent countries but powerful counter-arguments exist. The broader question is, at which level of government – regional, national, supranational – should policies be conducted? The theory of fiscal federalism deals with this question. The principle of subsidiarity is another way of approaching the issue. Both approaches are presented in detail in Chapter 3; they are briefly recalled in this section with a particular emphasis on fiscal policy.

17.3.1 Fiscal federalism

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

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

As noted before, spillovers lead to inefficient outcomes when each country is free to act as it wishes. Sometimes too much action is taken, sometimes not enough. In addition some policies are more efficient when carried out on a large scale. Increasing returns to scale can be found in the use of money,[7] in the design of commercial law or in defence (army, weapons development and production), among others.

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

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

Consider the example of common law concerning family life (marriage and divorce, raising children, dealing with ageing parents, etc.). Practices and traditions differ across countries, sometimes to a considerable

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

the spillovers that could result from *excessive* deficits are important; this is the logical basis for the Stability and Growth Pact.

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

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

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

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

Box 17.2 The deficit bias and the common pool effect

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

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

Once the source of the problem is identified, a solution can be envisioned. The common pool effect suggests that the budget process must be straightened out. Some countries legally limit the size of deficits; others require the government to decide on the deficit first, and only then to decide on spending and taxes; and yet others request a high degree of transparency, which undermines the influence of lobbies.

Table 17.3 documents the track record among a number of developed countries. For each country, it provides two pieces of evidence: in the first row, the proportion of years when the budget was in

Table 17.3 Deficit years during 1960–2014 in the OECD area (%)

	Australia	Austria	Belgium	Canada	Germany
%	81	83	96	74	77
Last surplus	2008	1974	2006	2007	2012
	Denmark	**Spain**	**Finland**	**France**	**UK**
%	51	79	25	91	85
Last surplus	2008	2007	2008	1974	2001
	Greece	**Ireland**	**Italy**	**Japan**	**Netherlands**
%	81	81	100	70	89
Last surplus	1972	2007		1992	2008
	Norway	**New Zealand**	**Portugal**	**Sweden**	**USA**
%	4	48	100	42	92
Last surplus	2014	2008		2008	2000

Sources: Economic Outlook, OECD and Eichengreen and Wyplosz (1993) for older data

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

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

A step was taken in 2011 with the adoption of a 'European semester'. The arrangement is described below. One objective is to synchronize budgetary planning in the EU, opening the door to cooperation. Another objective is to move ahead of national budgetary processes in the hope of framing them in accordance with the obligations of the Stability and Growth Pact. The European semester triggers discussions among governments and in the European Parliament and leads to jointly agreed recommendations by the Council.[8] Time will tell whether the European semester succeeds in injecting some degree of coordination effective enough to take into account the spillovers described in Section 17.2. Since this new coordination mechanism

[8] 'The Council' here refers to the Ministers for Economic and Financial Affairs and is called ECOFIN. For Eurozone decisions, ECOFIN includes only Ministers from member countries, casually referred to as the Eurogroup. The Eurogroup usually meets on the day before ECOFIN meetings.

Box 17.3 Fiscal policy coordination in the Eurozone

Following the crisis of 2010 and subsequent years, recovery was anaemic in 2014. A large number of countries, not merely the crisis countries, have again been asked to cut their budget deficits. This means a restrictive fiscal policy that stunts recovery. Policy coordination would deal with this situation by encouraging deficit reduction where needed while promoting a stronger recovery through spillovers from expansionary fiscal policies where the situation allows. In this exercise, the focus is on large countries that have a stronger income spillover effect on the Eurozone. Germany is in this situation, but the German authorities are still concerned that their budgetary situation is still fragile and worry about a return of inflation if growth is too rapid.

Without coordination, therefore, Germany will not adopt an expansionary fiscal policy and other countries will limit efforts at deficit reduction. The European semester is designed to promote coordination. At the conclusion of the 2014 exercise, the July European Council stated that '[it] is of the opinion that public finances in Germany remain sound overall as the medium-term objective is forecast to continue to be maintained and the debt rule respected'. In other words, there is no suggestion that Germany should change its fiscal policy stance. Earlier, when it concluded its annual review of German policies, the IMF considered that 'policies should focus on increasing growth in Germany while at the same time supporting the recovery in the euro area'.[1] This is more in line with coordination.

[1] The European council statement is available at: http://register.consilium.europa.eu/pdf/en/14/st10/st10783.en14.pdf. The IMF statement can be found at http://www.imf.org/external/np/ms/2014/051914.htm.

does not limit national sovereignty in any way, it is hard to imagine that much will be gained. Box 17.3 provides an example of the difficulties.

Ultimately, the debate has been ongoing for a decade and is unlikely to disappear for some time yet.[9] It pits those who attach much importance to spillovers and think that macroeconomic coordination is both promising and relatively easy to implement against those who see it as a collusion of self-interested governments.

17.4 The stability and growth pact

17.4.1 From convergence to the quest for a permanent regime

As explained in Chapter 16, admission to the monetary union requires a budget deficit of less than 3 per cent of GDP and a public debt of less than 60 per cent of GDP, or declining towards this benchmark. But what about afterwards, once in the monetary union? Could countries achieve the two fiscal criteria, join the monetary union and then freely relapse into unbridled indiscipline? Doing so would be against the spirit of convergence. The founding fathers of the Maastricht Treaty were keenly aware of this risk and, indeed, Article 126 unambiguously states that 'Member States shall avoid excessive government deficits' and then goes on to outline an 'excessive deficit procedure'. The Treaty left the practical details of the procedure to be settled later – and this is the task fulfilled by the Stability and Growth Pact (SGP) and its excessive deficit procedure (EDP).[10]

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

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

Adopted in 1997, the EDP was meant to be strictly enforced. However, because fiscal policy remains a national competence, the final say was given to the Council of Finance Ministers of the Eurozone, the Eurogroup. Acting on proposals from the Commission, which assumed the responsibility of being the Pact's 'tough cop', the Eurogroup has been loath to make decisions that would strongly antagonize its members, especially the finance ministers from the large countries. In November 2003, France and Germany were about to be sanctioned. Under pressure from the French and German finance ministers, the Eurogroup recanted and placed the SGP 'in abeyance'. This incident is recounted in Box 17.5. This episode confirmed the view that the SGP was not well designed. Recognizing that it was too rigid to be enforceable, governments and the Commission prepared a reformulation of the Pact. The new version was adopted in June 2005.

Then came the great financial crisis. Obviously, this was not the time to insist on a strict application of the SGP and nearly all countries were technically in excessive debt. The Commission issued a European Economic Recovery Programme, which implicitly accepted that it would take time to respect the SGP. At the same time, the Commission proposed to strengthen and expand the SGP, acknowledging that it had not delivered its promises even before the crisis.

This has led to yet another re-engineering of the SGP. Two new agreements, the so-called Six Pack–Two Pack, and one new Treaty, the Treaty on Stability, Coordination and Governance (TSCG, also called the Fiscal Compact) have added complexity and technicality to an already intricate arrangement.

17.4.2 The stability and growth pact

The SGP consists of five elements:

1. A definition of what constitutes an 'excessive deficit'.
2. A preventive arm, designed to encourage governments to avoid excessive deficits.
3. A corrective arm, which prescribes how governments should react to a breach of the deficit limit.
4. Procedures designed to embed each country's budget process within a European framework that is meant to be over-riding.
5. Sanctions.

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

Excessive deficits and debts

The Stability and Growth Pact considers that deficits are excessive when they are above 3 per cent of GDP. The public debt is excessive when it exceeds 60 per cent of GDP. These are the two convergence criteria described in Chapter 16, which also explains the logical connection between these values (Box 16.2).

The weakness of the deficit threshold is the existence of automatic stabilizers (see Section 17.1.3). When an adverse asymmetric shock occurs, the limit can be breached. At the same time, an adverse shock is just when a fiscal policy expansion is desirable. This is why the SGP also takes into account the structural budget balance, defined as the cyclically adjusted balance net of exceptional spending or revenues. The SGP requires that the structural budget always be in balance or surplus, with a deficit not in excess of 0.5 per cent of GDP.

The preventive arm

As explained in Section 17.2.4, many governments exhibit a deficit bias because of domestic pressure and political expediency. The SGP can exert counter-pressure in the form of peer pressure, called mutual surveillance. The preventive arm is designed to submit finance ministers to a collective discussion of one another's fiscal policy in the hope that doing so will help with budgetary discipline. This preventive arm is meant to circumvent using the politically sensitive corrective arm.

In 2013 a new version of the SGP was enacted; now each country defines its Medium Term Objective (MTO), the budget balance that it commits to achieving within a 3-year period. It must be compatible with 'minimum benchmarks' estimated by the European Commission. The benchmarks recognize the starting point for every country (budget balance, debt, growth). They are updated every 3 years.

Table 17.4 Minimum benchmarks and forecasts of structural budget balances (% of GDP)

	2012 Benchmarks	2014 Forecasts of 2013	2015 Forecasts of 2014
Belgium	−1.5	−2.3	−2.5
Germany	−1.5	0.3	0.0
Estonia	−1.8	0.2	−0.7
Ireland	−0.9	−4.8	−4.2
Greece	−1.8	2.0	−0.4
Spain	−1.4	−5.5	−3.4
France	−1.5	−2.3	−2.0
Italy	−1.5	−0.7	−0.7
Cyprus	−1.7	−5.1	−4.3
Latvia	−1.8	−1.5	−1.9
Lithuania	−1.8	−2.8	−1.3
Luxembourg	−1.6	0.3	−1.3
Malta	−1.8	−3.7	−2.9
Netherlands	−1.4	−2.3	−0.8
Austria	−1.8	−1.7	−1.1
Portugal	−1.8	−2.0	NA
Slovenia	−1.7	−3.3	−2.4
Slovakia	−1.9	−2.4	−1.8
Finland	−0.7	−0.5	−0.3

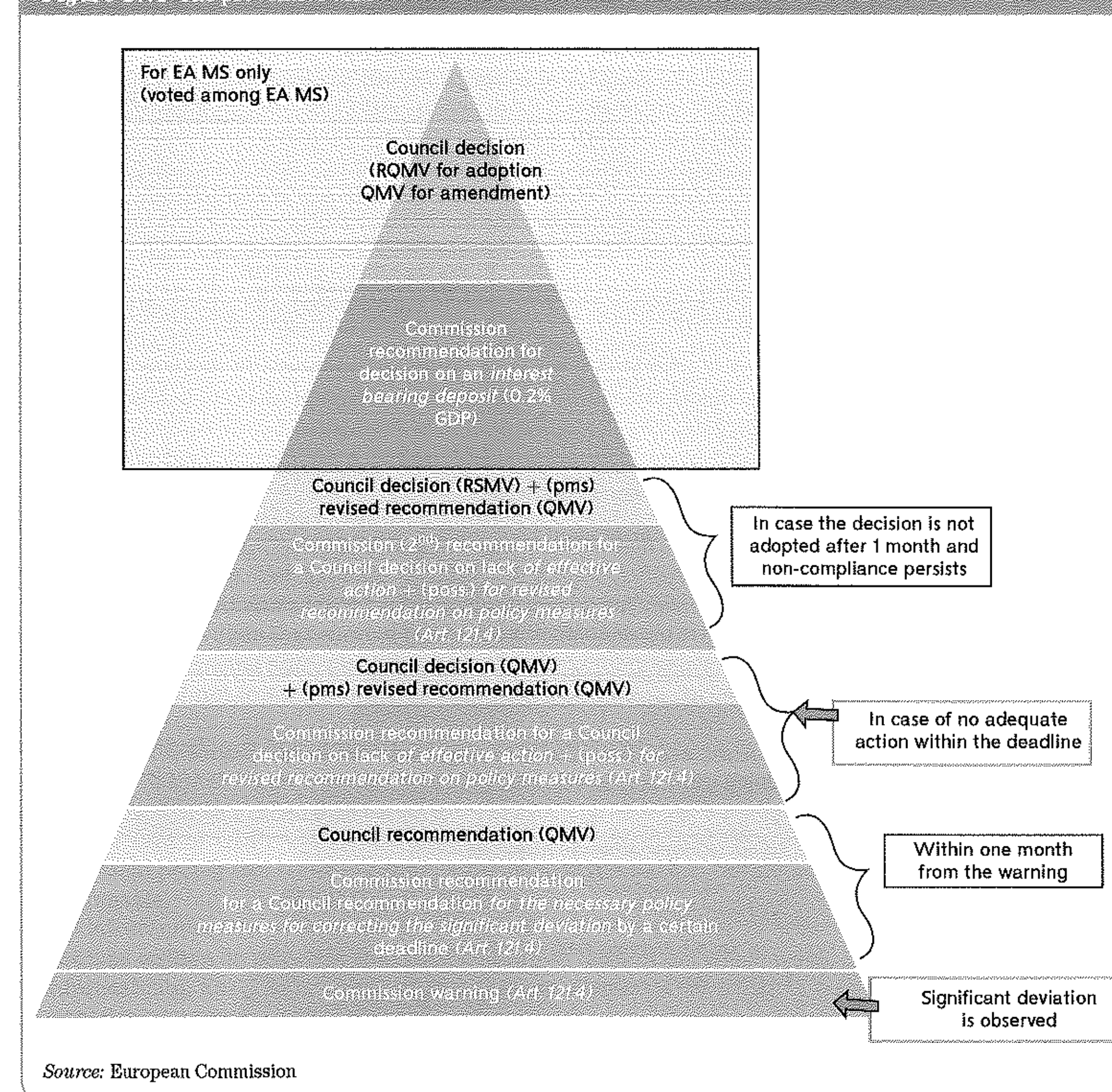
Sources: Columns 1 and 2: European Commission, Public Finances in EMU, 2013. Column 3: AMECO, European Commission

Table 17.4 presents the first benchmarks established in late 2012, and therefore for the 2015 horizon, along with the Commission's forecasts produced in 2013 for 2014 (forecasts for 2015 were not available then) and those of 2014 for 2015.

The 2011 reform of the SGP also introduced the European semester. This semester begins in January with the publication of the SGP's forecasts for the years to come, which is a way of harmonizing expectations and limiting unduly optimistic national forecasts that lead to unrealistic budget previsions. Then, in early spring, each EU government submits its Stability and Convergence Programme. Along with other policy objectives, the programme includes 'medium-term budgetary strategies', essentially a statement of intentions covering the next 3 years. The crucial issue at this stage is how each government intends to achieve its MTOs year by year. The Commission assesses these programmes and determines whether they are realistic and compatible with the MTOs. If they are not, the government is asked to adjust its intentions in good time before the next annual budget is submitted to parliament. The adopted budget is then evaluated by the Commission, which then forwards its views to the Council. The Council then examines each country's budget and makes public recommendations in early July, which concludes the exercise. The Council's recommendations are meant to shape the next steps, when budgetary proceedings revert back to the national level.

What happens if a country adopts a budget that is not in conformity with the requirements put forward by the Council? This triggers a procedure summarized in Figure 17.4: warnings and recommendations follow in quick succession. The ultimate sanction is a fine of 0.2 per cent of the country's GDP, which takes the form of an interest-bearing deposit; these resources are frozen until the procedure is lifted. Importantly, the decision is adopted by the Council, following a recommendation by the Commission, through a procedure called reversed qualified majority voting (RQMV). This means that the Commission's proposal is adopted unless a majority of votes, weighted by country size, decides against it.[11] The intention is to make Commission proposals more likely to be adopted.[12] The preventive arm applies to all EU countries but fines can only be imposed on Eurozone member countries. In effect, the SGP is binding only on these latter countries.

Figure 17.4 The preventive arm



Source: European Commission

[11] A qualified majority requires at least two-thirds of the votes cast.

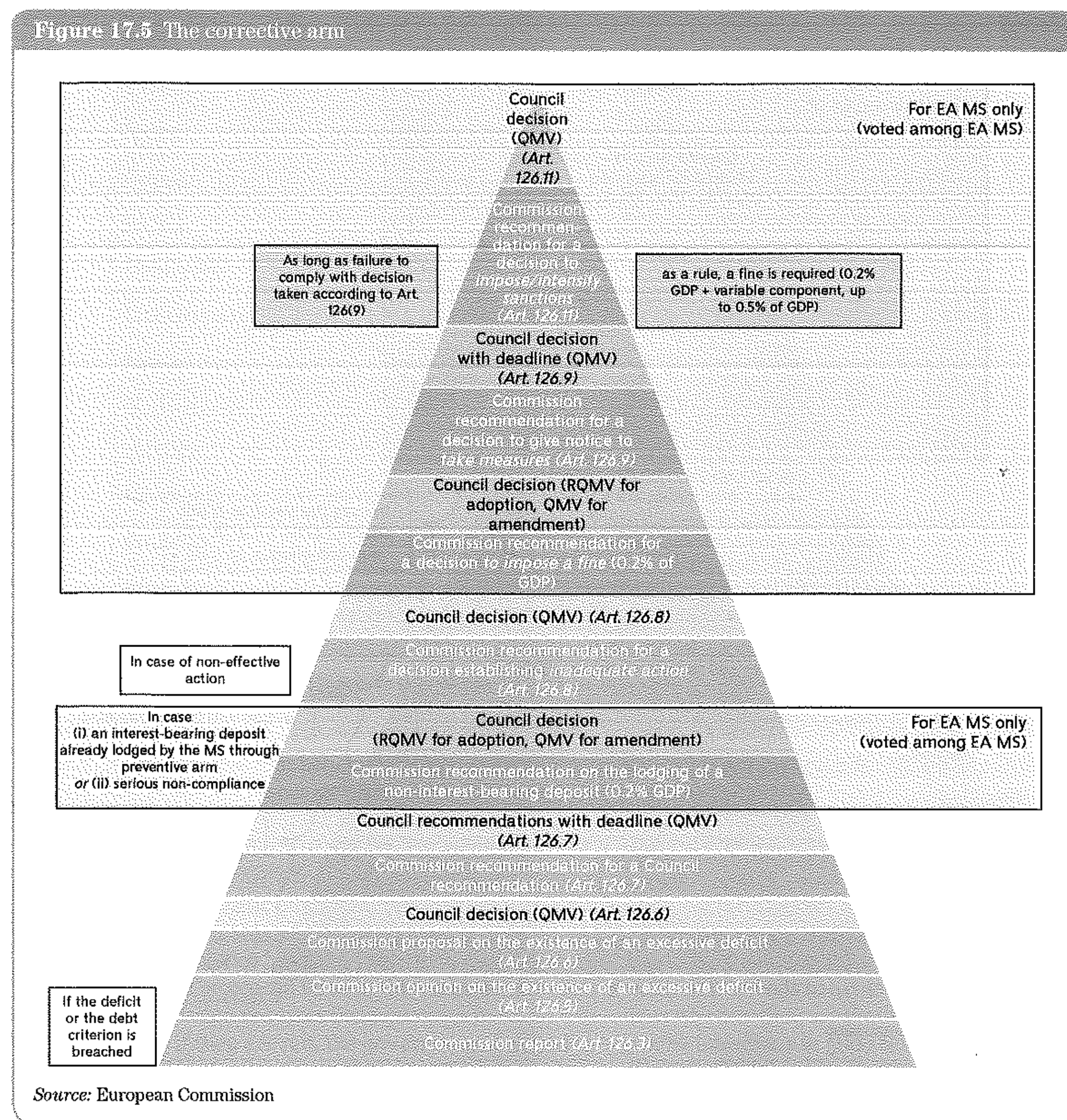
[12] This is a direct response to the 2003 decision not to sanction France and Germany. The two largest countries mustered enough votes to fail to approve the Commission's proposal.

The corrective arm

When a country does not meet the requirements of the SGP – the 3 per cent deficit and 60 per cent debt limits – it is declared in excessive deficit by the Council. The decision is made through qualified majority voting (QMV) upon a recommendation from the Commission. Given that most Eurozone countries have debts vastly in excess of 60 per cent, the EDP only applies if a country above the threshold has not reduced its debt by at least 0.5 per cent of GDP on average over the previous 3 years.

The Council applies gradually increasing peer pressure, described in Figure 17.5. In brief, the Council adopts recommendations that are increasingly detailed and urgent when the recommended course of action is not followed. After several failures to comply, a sanction procedure is triggered. Following a next-to-final

Figure 17.5 The corrective arm



Source: European Commission

warning adopted by RQMV, the Council imposes a sanction by QVM. The sanction is a deposit worth 0.2 per cent of the delinquent country's GDP. Further non-compliance may result in additional fines up to a maximum of 0.5 per cent of GDP.

Appraisal

Several aspects of the EDP are noteworthy. First, formally, it does not remove fiscal policy sovereignty. Governments are in full control; they only agree to bear the consequences of their actions. The procedure involves recommendations, not orders by the Council. At the end of the day, governments and their parliaments decide fiscal policy, and policy-makers care about voters not about 'Europe'. Sanctions are intended to weigh in. It remains the case that both recommendations and sanctions may result in hardening public opinion against 'Europe'.

Second, the intent is clearly pre-emptive. The preventive arm is designed to avoid reaching the stage of corrective action and even then a lengthy procedure is involved between the time a deficit is deemed excessive and when a fine is imposed. Finally, all decisions are in the hands of the Council, a highly political body that can exploit many of the 'ifs' included in the SGP.

As already indicated, the EDP applies to all EU countries but fines can only be imposed on Eurozone member countries. By mid-2014, 17 EU countries were declared to be in excessive deficit (the exceptions were Bulgaria, Germany, Estonia, Italy, Hungary, Latvia, Lithuania, Luxembourg, Romania, Finland and Sweden). At the depth of the crisis, in the spring of 2011, 24 of the 28 EU Member States were declared to be in excessive deficit. No sanction has ever been imposed.

17.4.3 The Treaty on Stability, Coordination and Growth

Most of the elements of the Treaty on Stability, Coordination and Growth (TSCG), adopted in 2012, are included in the SGP. There is one novel element that is of a different nature, however. It requires that every country adopt a budget rule enshrined in high-level legislation. It also mandates the setting up of a watchdog council composed of independent experts. The intent is to further strengthen the SGP by making fiscal discipline a national obligation, not just a requirement set and implemented at the European level.

Inadvertently, perhaps, this treaty could change the situation. The heavy machinery of the SGP (European semester, Commission surveillance and Council decisions) is designed to affect national debates about fiscal policy. Yet national debates are national, filled with unavoidable domestic considerations often far removed from taking into account the importance of fiscal discipline. The Commission easily emerges as the villain that encroaches on an area of national sovereignty. The Commission's response, that it merely implements agreements voluntarily adopted by member countries, often elicits hostility to these agreements, if not toward European integration. The TSCG shifts the debate: it is national laws that must be respected.

The TSCG actually specifies what type of rule is required. Its prescription is the 'debt brake' arrangement inscribed in the German constitution in 2009. This arrangement, inspired by the Swiss debt brake of 2001, is described in Box 17.4. It is based on a simple rule: the cyclically-adjusted budget must never exceed 0.35 per cent of GDP. As explained in the box, the rule is flexible in the short run and strict in the long run. Fiscal policy can be used counter-cyclically when needed but fiscal discipline is non-negotiable and enforceable.

Unfortunately, the TSCG is not very precise. It recommends 'in principle' the German rule and asks that it be written 'in principle' into each country's constitution, which would provide a strong guarantee of enforceability. Early indications are that implementation of the treaty is very much *à la carte*, with many countries adopting complex rules not written into the constitution (perhaps because they are too complex). Complexity and lower-level law make it possible to ignore the rule.

Another prescription of the TSCG is that each country subjects its budget laws to the scrutiny of a committee of independent experts before adoption. A growing number of countries have established such fiscal councils worldwide. They can play an important role. They usually are tasked to examine how the budget is constructed and to spot unreasonable assumptions and calculations. They can also bless

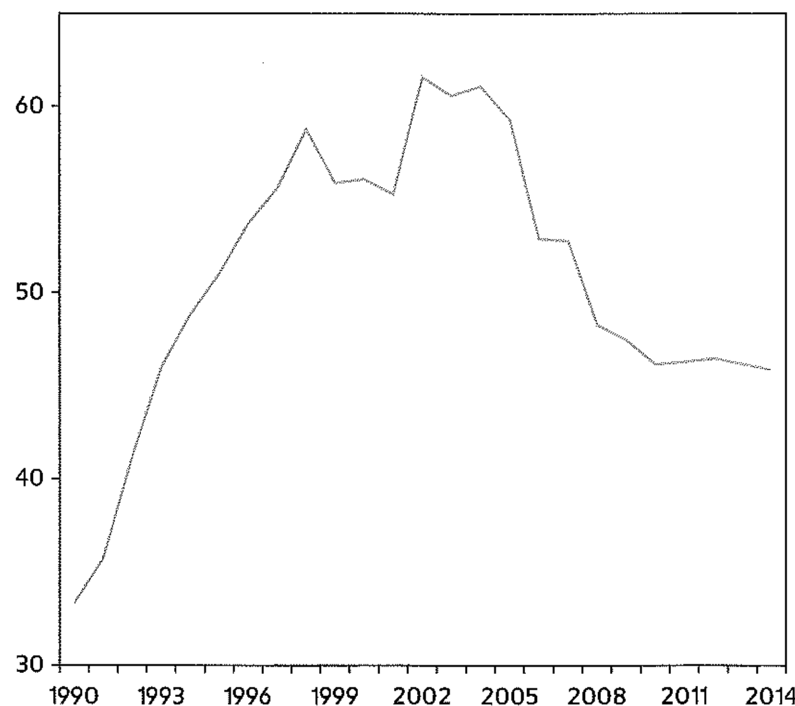
Box 17.4 The German debt brake

The German debt brake rule requires that the budgets of the federation and of the Länder be in balance. This requirement is deemed satisfied if the federal structurally-adjusted deficit does not exceed 0.35 per cent of GDP. The Länder have no such derogation. If, for unforeseeable reasons, the deficit exceeds the threshold, the corresponding excess is noted down as a debit in a control account. Better outcomes are credited positively into the control account. If the account debit exceeds 1.5 per cent, the federal government must empty the account 'in a manner appropriate to the cyclical situation'.

The arrangement has many advantages over the EDP. First, it is simple and therefore not subject to interpretation. Second, being defined in cyclically-adjusted terms, it allows the automatic stabilizers to fully operate. Third, even better, deviations are allowed, which leaves room for some discretion; later, however, these deviations must be corrected. Fourth, again in contrast to the SGP, the correction does not have to be executed immediately, only 'in a manner appropriate to the cyclical situation', which leaves space in which to wait for better times. Importantly, the obligation to correct accumulated lapses implies that bygones are not bygones; the government knows ex-ante that it will have to compensate any slippage through subsequent surpluses. Finally, the rule is a constitutional requirement. The all-powerful Constitutional Court of Karlsruhe will see to it that the rule is respected.

The debt brake is being progressively applied, so it is too early to observe its full effect. The Swiss debt brake, which served as a model for Germany, has been in place since 2002. Figure 17.6 presents the evolution of the Swiss federal government debt. Obviously, fiscal discipline did not exist in Switzerland before the adoption of the debt brake. However, the impact of a simple and clever rule has led to a clear break from the past.

Figure 17.6 Switzerland: federal government debt (% of GDP)



Source: Economic Outlook, OECD

temporary flexibility in bad years – deviations from the rule, when it exists – while insisting on rigorous discipline in good years.[13] Here again, while some countries have established high quality fiscal councils, others have made sure that the government will not be subject to strong criticism.

17.4.4 Why the pact is controversial

Counter-cyclical fiscal policies: how much room to manoeuvre?

The automatic response of budget balances to cyclical fluctuations, recalled in Section 17.1.3, is a source of difficulty for the EDP because much of its machinery, including the sanction mechanism, focuses on the 3 per cent deficit and the 60 per cent debt limits. The logic is that, in normal years, budgets should be balanced or in surplus to leave enough room for the automatic stabilizers to come into play in bad years without breaching the 3 per cent limit.

Mindful of this problem, the reforms of the SGP have put increasing weight on the structural budget. As it conducts surveillance, the Commission interprets the budgetary situation by recognizing that a budget balance can deteriorate automatically when the economic situation worsens. Indeed, the corrective arm urges governments to aim at surpluses during good years (with a formal definition of what a good year actually is). Still, when a country is declared in excessive deficit, it is not allowed to let the automatic stabilizers play their shock-absorbing role. The same applies to countries with debts in excess of 60 per cent of GDP, which are required to cut indebtedness by 0.5 per cent per year, a requirement that applies to 13 out of 18 Eurozone member countries (as of mid-2014).

The upshot is that many member countries are forced to conduct pro-cyclical fiscal policies in bad times, with a contractionary effect. The result is shown in Figure 17.7, which plots changes in the output gap between 2008 (before the Eurozone crisis) and 2014 on the horizontal axis, and of the cyclically-adjusted budget balance (net of debt service) on the vertical axis. If fiscal policies are counter-cyclical, a decline in the output gap should be associated with a worsened structural balance as fiscal policy becomes expansionary. Figure 17.7 shows that output gaps have worsened everywhere in the Eurozone and that the structural balances have increased everywhere except Finland and Germany. In fact, the worse has been the decline in output gap, the more the structural budget has improved. Put differently, the countries that adopted the more contractionary fiscal policies are those where the recession has been deeper. This suggests a two-way causality: the recession has subjected all countries to the excessive deficit procedure and the SGP has promoted contractionary fiscal policies. These policies, in turn, have led to deeper falls in output gap.

Controversies

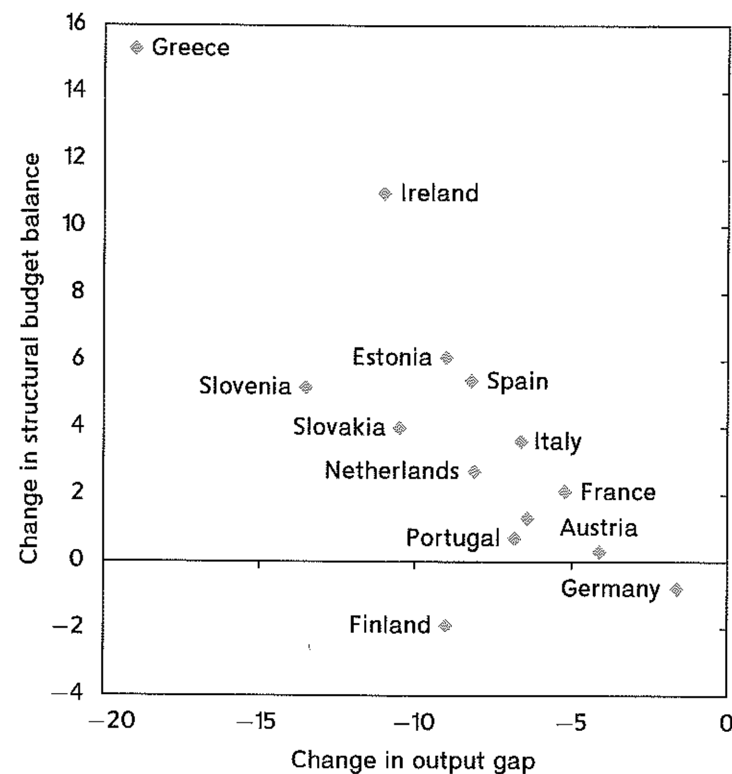
The Stability and Growth Pact is the arrangement adopted to establish much needed fiscal discipline in the EU in general, and especially in the Eurozone. Its logic is to provide a strong incentive for each government to bring its budget into balance, or even surplus in good years, so that fiscal policy can be used as a counter-cyclical instrument in bad years. This is a good principle, for all countries anywhere in the world. Yet, the SGP has become intensely controversial, and not simply because of the crisis.

A first hurdle is the starting position. Had all countries achieved budget surpluses before adopting the euro, it would have been much easier to operate the SGP as intended. The convergence criteria, however, only required a deficit of less than 3 per cent and, as Figure 16.2 shows, many did marginally better. The early years of the euro were mostly good years, sometimes even very good years, but 'Maastricht fatigue' – efforts to meet the criteria – set in and few countries took advantage of the economic situation to carry out the required clean-up. This eventually led to the adoption of the preventive arm, but the crisis occurred before the budgets had been suitably improved. The impact of the SGP during the crisis, following a serious tightening of the rules in 2011–12, led to the adoption of pro-cyclical policies at the worst possible time (Figure 17.6). This is the 'bad luck' interpretation of the SGP. It implies that the efforts of the crisis years represent a good start and have to be sustained until surpluses are achieved.

When the SGP was under discussion, one view was that it should be entirely automatic, with each step, including sanctions, to be decided by the Commission on the basis of a transparent and unambiguous

[13] During the crisis, the Swedish committee asked for a more expansionary fiscal policy than planned by the government. The government dutifully obliged.

Figure 17.7 Pro-cyclical fiscal policies during the crisis, 2008–14



Note: Vertical axis: change in the ratio of output gap to GDP (%); horizontal axis: change in the ratio of cyclically-adjusted balance to GDP (%).

Source: Economic Outlook, OECD

roadmap. On the other hand, in every democracy, deciding who will pay taxes and how much, and how public money is to be spent, is in the hands of elected officials. An automatic application of the SGP, including detailed mandatory recommendations, would clearly violate this basic principle of democracy. This is why, in the end, enforcement of the SGP was entrusted to the Council of Economic and Finance Ministers. But finance ministers are, by definition, politicians. As such, they make elaborate calculations involving tactical considerations. Another view is that governments will never want to humiliate each other, as in 2004, as recalled in Box 17.5. A related view is that it is wrong to rely on external pressure in a process that remains in the domain of domestic sovereignty.

Box 17.5 The Commission vs. the Council

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

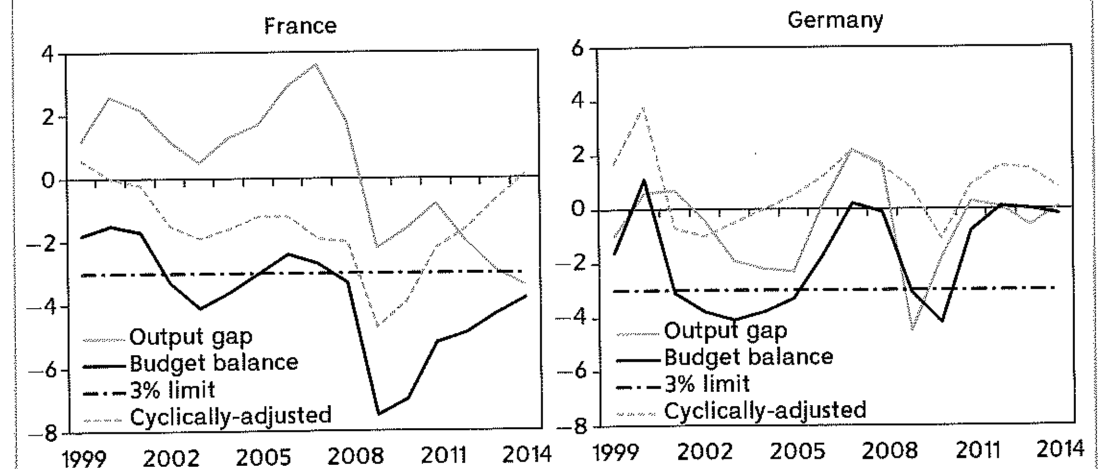
For 2001, France had announced a deficit of 1.4 per cent of GDP, but the outcome was 2.7 per cent. In 2002, the deficit reached 3.2 per cent of GDP. By June 2003, a further deterioration was visible, partly because President Chirac reduced income taxes in both years following an election campaign promise. The Council accepted the Commission recommendation to trigger the excessive deficit procedure.

By November 2003, it had become clear that France and Germany were not heeding the recommendations. Their 2003 deficits, not yet known, both transpired to be 3.7 per cent of GDP, and forecasts for 2004 and 2005 did not envision a return to below 3 per cent. This led the Commission to issue mandatory recommendations, the last step before sanctions. After intense lobbying by France and Germany, the Council decided by qualified majority to 'hold the excessive deficit procedure for France and Germany in abeyance for the time being'. An outraged Commission took the Council to the Court of Justice of the European Communities. The Court subsequently annulled this decision, mostly on legal technical grounds. It considered that the wording of the Council decision was not laid out in conformity with the treaty. The Council promptly confirmed the substance of its decision with adequate wording. The Commission claimed victory. By then, however, deficits had declined and the issue was moot.

An amusing episode followed. In 2003, the Dutch deficit stood at 3.2 per cent, the result of a long slowdown. As it was expected to fall below 3 per cent in 2004 and afterwards, no action should have been taken. But the Dutch government, which had led the resistance against the French and German whitewash in November 2003, was keen to restore credibility to the EDP. It asked to be declared in excessive deficit and its request was granted.

The abeyance episode was a lesson well learned. It led to the first major revision of the SGP, in 2005. The lesson drawn then was that the SGP was too strict, leaving the Commission with no choice but to recommend the EDP for France and Germany. Flexibility was achieved by introducing the cyclically-adjusted balance as an additional criterion in 2005. Indeed, as Figure 17.8 shows, neither country breached the 3 per cent limit under this criterion in 2003–04. Afterwards, however, while Germany endeavoured to achieve fiscal discipline, France did not. By the time of the next revision, in 2011, it was concluded that the SGP had been too flexible.

Figure 17.8 France and Germany: output gap and budget balance (% of GDP)



Source: Economic Outlook, OECD

Implicit liabilities

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

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

The SGP requires that member governments start planning for the ageing phenomenon. But there is no hard data, merely forecasts focused on decades into the future. As a result, enforcement is impossible and, indeed, the Commission only uses this consideration to colour its diagnosis. Yet, the amounts involved are potentially huge, possibly even dwarfing current debt levels.[14] Why focus the whole pact on existing deficits and debts, then? The answer – because they are measurable – is not particularly convincing.

17.5 The macroeconomic imbalance procedure

Figure 16.16 shows that the external balances of Eurozone countries have increasingly diverged since they adopted the euro. In theory, such imbalances should be self-correcting but the Hume mechanism has not worked well. Institutional arrangements and politics have stood in the way of wage and price adjustments made necessary by the absence of national exchange rates. Something must be done about it. The response is the macroeconomic imbalance procedure (MIP) introduced in 2012 alongside the reform of the excessive deficit procedure.

The formal apparatus of the MIP parallels that of the EDP. It has both preventive and corrective arms and can lead to sanctions after graduated admonitions proposed by the Commission and adopted by the Council by RQMV. The big difference is that the EDP rests on precise and quantified criteria, the deficit and debt ceilings, while the MIP relies on a 'scoreboard', that is, a large number of indicators, including external balances, the evolution of labour costs, unemployment, financial conditions and more. All EU countries are subject to the MIP but only Eurozone countries can be fined.

The heart of the MIP is the Alert Mechanism Report, which is published once a year. It identifies countries that the Commission considers to be in potential difficulty. This triggers an in-depth review, which can lead to recommendations and, ultimately, to possible sanctions of up to 1 per cent of GDP. In 2014, the Commission identified 16 EU countries that required an in-depth review.

17.6 Summary

The loss of national monetary policy leaves fiscal policy as the only macroeconomic instrument for each Eurozone member country. Its importance is reinforced by the absence of intra-Eurozone transfers, one of the OCA criteria not satisfied in Europe.

Fiscal policy operates in two ways:

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

[14] Some estimates put the implicit liabilities at 100–300 per cent of GDP.

However, undisciplined fiscal policy results in high public indebtedness. Indeed, there is a well-documented budget deficit bias as governments are eager to please voters with generous spending not financed by commensurate tax revenues.

Within a monetary union, fiscal indiscipline in one country affects other countries through a number of spillover channels:

- Income flows via exports and imports.
- The cost of borrowing, as there is a single interest rate.
- The fear that a default by a government on its public debt would hurt the union's credibility.

The presence of spillovers argues in favour of coordination of fiscal policies within a monetary union. In practice, however, fiscal policy coordination is difficult. Member States have retained full sovereignty in budgetary matters and budgets are both highly political and a key element of democratic oversight by national parliaments.

The theory of fiscal federalism provides arguments for and against the sharing of policy instruments. On the one hand, the presence of spillovers and of increasing returns to scale argues for policy sharing. On the other hand, the principle of subsidiarity suggests exercising caution in the centralization elements of fiscal policy. The existence of national differences in economic conditions and preferences, and of asymmetries of information, argues against policy sharing. The quality of government also matters.

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

- A definition of what constitutes an 'excessive deficit'.
- A preventive arm, designed to encourage governments to avoid excessive deficits.
- A corrective arm, which prescribes how governments should react to a breach of the deficit limit.
- Procedures designed to embed each country's budget process within a European framework, the European Semester, which is meant to constrain national parliaments.
- Sanctions.

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

- From an economic viewpoint, targeting the annual budget deficit can lead to pro-cyclical policies, i.e. policies that reinforce either a slowdown or a boom. Revisions of the SGP have moved the focus somewhat to cyclically-adjusted budgets and the debt level.
- From a political viewpoint, the SGP faces a formidable contradiction. Fiscal policy is a matter of national sovereignty, in the hands of democratically elected governments and parliaments. At the same time, fiscal policy is recognized as a matter of common concern.

The EDP has been complemented with a Macroeconomic Imbalance Procedure (MIP) that runs in parallel to it. It rests on a scoreboard of indicators designed to identify early on unsustainable external deficits, excessive labour costs and prices that cannot be corrected though exchange rate depreciation and a host of other potential threats to macroeconomic stability.

Self-assessment questions

1. What is the difference between actual and cyclically-adjusted budgets? Why are discretionary actions visible only in changes of the cyclically-adjusted budget balance?
2. In Figure 17.1, identify years when fiscal policy is pro-cyclical, and years when it is counter-cyclical.
3. What are externalities and spillovers? How do they operate in the case of fiscal policy?

4. Explain the no-bailout clause.
5. What is the intended purpose of the Stability and Growth Pact?
6. In Table 17.4 identify countries that have performed better than their medium-term targets and countries that have performed less well.
7. Compare the Stability and Growth Pact and the German debt brake.
8. Explain why fiscal policy would be strictly confined to the automatic stabilizers if the SGP required that the cyclically-adjusted budget be balanced every year. What difference would it make if the cyclically-adjusted budget had to be balanced on average over business cycles?
9. Why are fines under the Stability and Growth Pact sometimes described as pro-cyclical fiscal policy?
10. Why is there a contradiction between the Stability and Growth Pact and sovereignty in budgetary matters?

Essay questions

1. Compare majority voting, qualified majority voting and reverse qualified majority voting.
2. Does a debt default by a member country make it impossible for this country to remain in the Eurozone?
3. Some countries argue that the monetary union needs a common fiscal policy to match the common monetary policy. Evaluate this view.
4. In making its decision on whether to join the Eurozone, the UK Treasury studied the Stability and Growth Pact and stated:

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

Interpret and comment.

Further reading: the aficionado's corner

The European Commission's website provides a detailed presentation of the SGP and the MIP. See, for instance:
http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm
http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm.

On the tendency of governments to not always serve their citizens' interests and what it means for the EU, see:
Persson, T. and G. Tabellini (2000) *Political Economics*, MIT Press, Cambridge, MA.
Vaubel, R. (1997) 'The constitutional reform of the European Union', *European Economic Review*, 41(3–5): 443–50.

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

On ways to reform the SGP:
Wyplosz, C. (2011) 'Fiscal discipline: rules rather than institutions', *National Institute Economic Review* 217, August.

A defence of the SGP, by one of its creators (J. Stark):
Schuknecht, L., P. Moutot, P. Rother and J. Stark (2011) *The Stability and Growth Pact: Crisis and Reform*, Occasional Paper No. 129, European Central Bank.

The **VoxEU** website contains a wealth of relevant analyses, among them:

On austerity policies:
http://www.voxeu.org/debates/has-austerity-gone-too-far.

On the difficulty faced by fiscal policies because of poor information and what it means for the SGP:
http://www.voxeu.org/article/do-fiscal-policymakers-know-what-they-are-doing.

The Commission's view in June 2014:
http://www.voxeu.org/article/delivering-eurozone-consistent-trinity.

On the benefits of policy coordination:
http://www.voxeu.org/article/spillovers-why-macro-fiscal-policy-should-be-coordinated-economic-unions.

On the role of independent fiscal agencies:
http://www.voxeu.org/article/fiscal-forecasts-governments-vs-independent-agencies.

On the cyclical behaviour of fiscal policy, see:
European Commission (2001) 'Fiscal policy and cyclical stabilization in the Eurozone', *European Economy*, 3: 57–80.
Hallerberg, M. and R. Strauch (2002) 'On the cyclicality of public finances in Europe', *Empirica*, 29: 183–207.
Melitz, J. (2000) 'Some cross-country evidence about fiscal policy behaviour and consequences for the Eurozone', *European Economy*, 2: 3–21.

For analyses on the politico-economic aspects of fiscal policy, see:
Alesina, A. and R. Perotti (1995) 'The political economy of budget deficits', *IMF Staff Papers*, 42(1): 1–37.
Hagen, J. von and I.J. Harden (1994) 'National budget processes and fiscal performance', *European Economy Reports and Studies*, 3: 311–408.
Persson, T., G. Roland and G. Tabellini (2000) 'Comparative politics and public finance', *Journal of Political Economy*, 108(6): 1121–61.

For an introduction to the theory of fiscal federalism, see:
Oates, W. (1999) 'An essay in fiscal federalism', *Journal of Economic Literature*, 37(3): 1120–49.

On fiscal rules:
Bordo, M., L. Jonung and A. Marliewicz (2011) 'A fiscal union for the Euro: some lessons from history', VoxEU, http://www.voxeu.org/index.php?q=node/7007.
IMF (2009) 'Fiscal rules – anchoring expectations for sustainable public finances', http://www.imf.org/external/np/pp/eng/2009/121609.pdf.
Wyplosz, C. (2011) 'Fiscal discipline: rules rather than institutions', *National Institute Economic Review*, 217: R19–R30.

On independent fiscal policy watchdog committees:
OECD (2013) *Principles for Independent Fiscal Institutions*,
http://www.pbo-dpb.gc.ca/files/files/Revised%20IFI%20Principles_EN%20-%2013-Feb-13.pdf.

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Eichengreen, B. and C. Wyplosz (1993) 'Unstable EMS', *Brookings Papers on Economic Activity*, 1: 51–144.
OECD (1997) *Economic Outlook*, OECD, Paris.
Stark, J. (2001) 'Genesis of a pact', in A. Brunila, M. Buti and D. Franco (eds) *The Stability and Growth Pact*, Palgrave, Basingstoke.