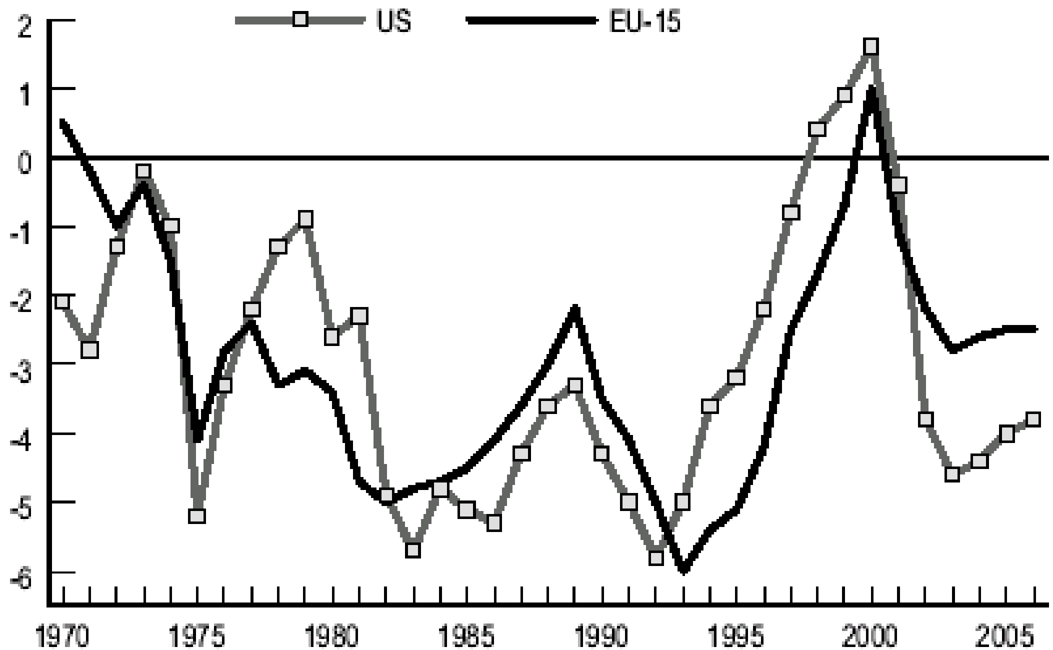
Fiscal policy in Europe and the stability pact

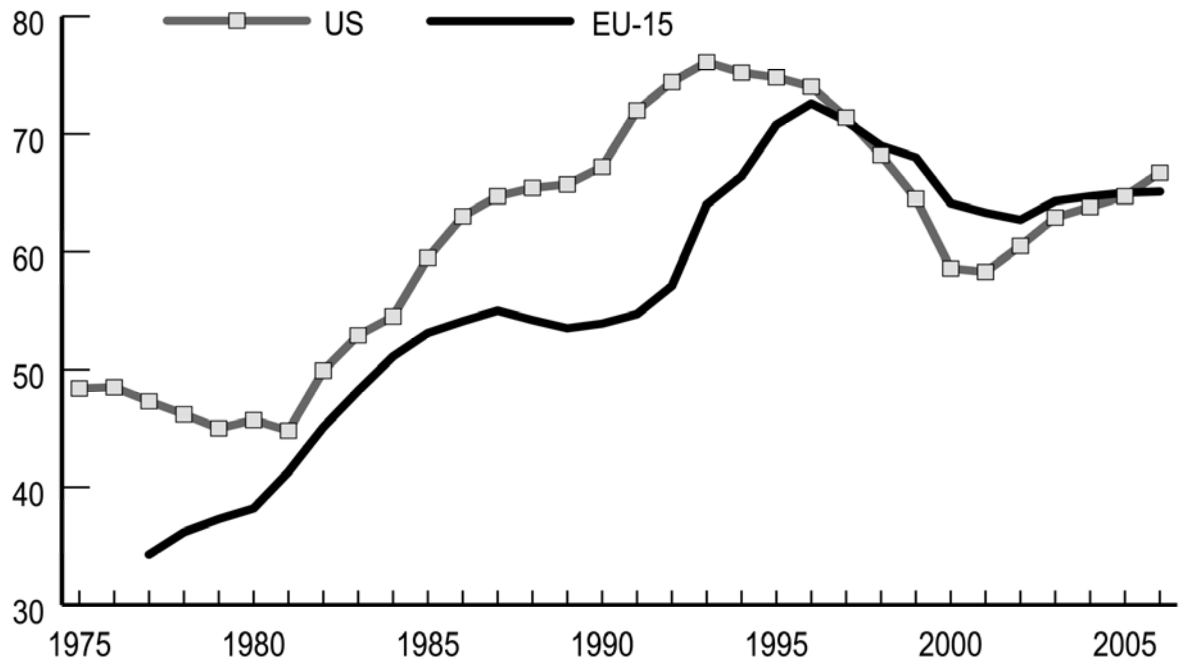
Figure 1 Net government lending (per cent of GDP), 1970-2006



Notes: EU-15: Until 1994 ESA-79 definition, from 1995 ESA-95 definition. 2005 and 2006 values are estimates using data up to 16 March 2005.

Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

Figure 2 Gross government debt (per cent of GDP), 1975-2006



Note: 2005 and 2006 values are estimates using data up to 16 March 2005.

Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

Table 5a Gross government debt in the EU-15 countries (per cent of GDP), 1997-2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Austria	64.6	**65.0**	**67.4**	66.7	**67.1**	66.7	65.4	65.2	64.4	64.1
Belgium	124.8	119.6	114.9	109.1	108.0	105.4	100.0	95.6	94.9	91.7
Finland	54.1	48.6	47.0	44.6	43.8	42.5	**45.3**	45.1	44.3	43.7
France	59.3	**59.5**	58.5	56.8	57.0	59.0	63.9	65.6	66.2	67.1
Germany	**61.0**	60.9	**61.2**	60.2	59.4	**60.9**	**64.2**	**66.0**	**68.0**	**68.9**
Greece	**114.0**	112.4	112.3	**114.0**	**114.8**	112.2	109.3	110.5	110.5	108.9
Ireland	64.7	53.7	48.7	38.3	35.8	32.6	32.0	29.9	29.8	29.6
Italy	120.5	116.7	115.5	111.2	110.7	108.0	106.3	105.8	105.6	**106.3**
Luxembourg	6.8	6.3	6.0	5.5	7.2	7.5	7.1	7.5	7.8	7.9
Netherlands	69.9	66.8	63.1	55.9	52.9	52.6	54.3	55.7	57.6	57.9
Portugal	59.1	55.0	54.3	53.3	55.9	58.5	**60.1**	**61.9**	**66.5**	**67.5**
Spain	66.6	64.6	63.1	61.1	57.8	55.0	51.4	48.9	46.5	44.2
Euro area	75.1	74.3	72.9	70.4	69.6	69.5	**70.8**	**71.3**	**71.7**	**71.9**
Denmark	65.7	61.2	57.7	52.3	47.8	47.2	44.7	42.7	40.5	38.2
Sweden	70.6	68.1	62.8	52.8	54.3	52.4	52.0	51.2	50.3	49.2
UK	50.6	47.5	45.0	42.0	38.8	38.3	39.7	41.6	41.9	42.5
EU-15	71.1	69.0	68.0	64.1	63.3	62.7	**64.3**	**64.7**	**65.0**	**65.1**

Notes: 2005 and 2006 values are estimates using data up to 16 March 2005. Cases where the debt ratio is above 60 per cent of GDP and not falling are shown in bold.

Source: *Statistical Annex of European Economy*, Spring 2005, European Commission.

Deficit bias

- Political business cycles
  - expenditure increases and tax cuts before elections
- ”The tragedy of the commons”
  - lobbying by interest groups
- Strategic behaviour
  - favouring of the own constituency when in power in a system where political parties alternate in government
- Time inconsistency problems
  - employment concerns (same motives as for inflation bias in monetary policy)

Consequences of large budget deficits

- Undesirable reallocation of public and private consumption over time
- Higher interest rates
- Risk of higher inflation
- Risk of government bankruptcy *or* draconian budget cuts when action is taken
- A monetary union is likely to exacerbate a deficit bias
  - the costs can partly be shifted on to other countries

EU fiscal rules

<u>The Maastricht Treaty</u>

- No-bail-out clause
  - nor the ECB nor other EU governments are allowed to bail out another EU government
- The excessive deficit procedure
  - maximum deficit of three per cent of GDP unless exceptional circumstances
  - maximum government debt of 60 per cent of GDP: if the debt is higher it must be ”diminishing at a satisfactory pace”
  - Specified procedure to be followed in case of violations of the rules

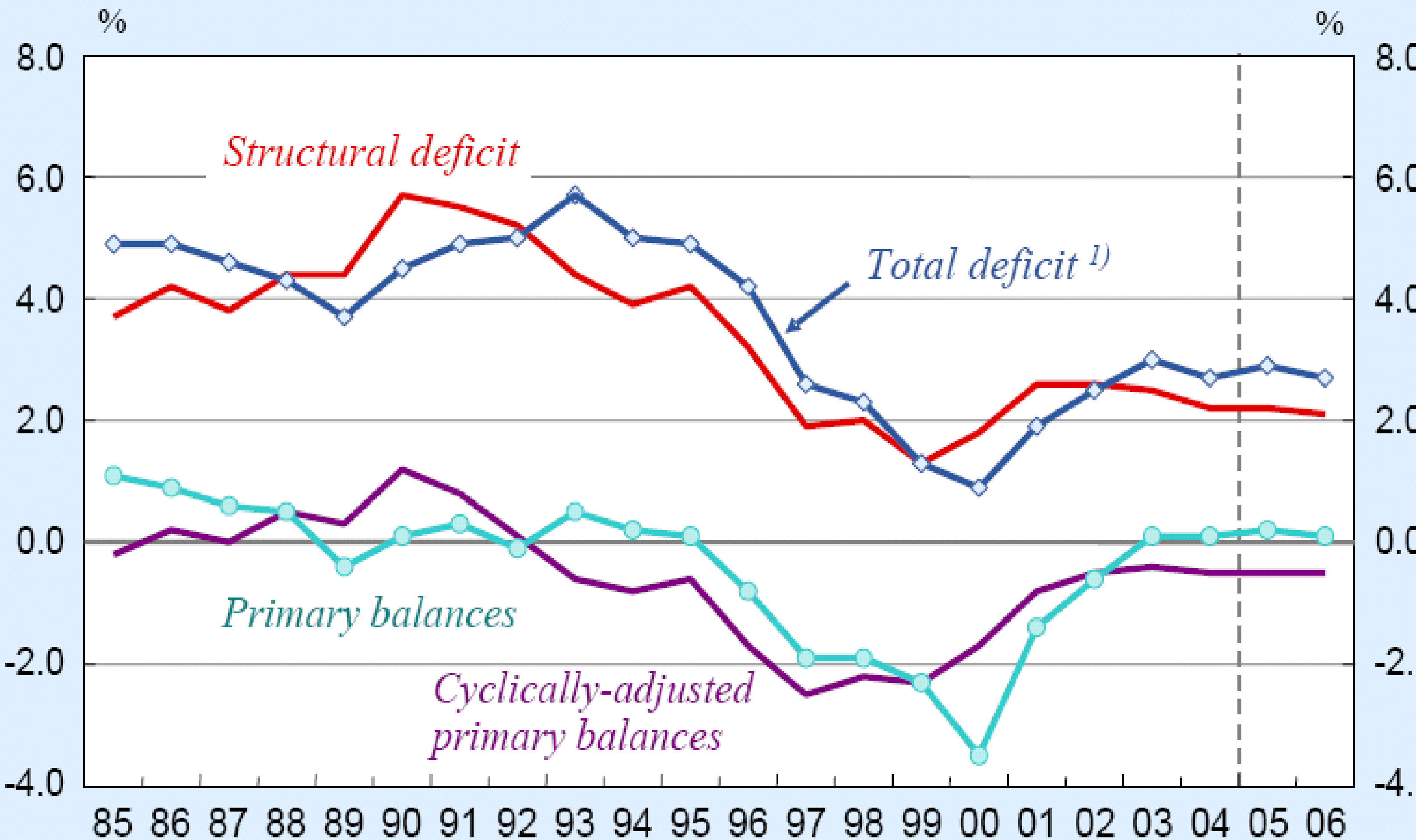
The Stability and Growth Pact

- Operationalisation of the stipulation in the Treaty
- *Deposits* that can be converted into *fines* of up to 0.5 per cent of GDP
- Medium-term budget target of ”close to balance or in surplus”
- The structural budget balance/cyclically adjusted budget balance should be close to zero

Fig. 1.7

GOVERNMENT BUDGET DEFICIT IN THE EURO AREA

as a percentage of GDP



1) Excluding one-off revenues from the sale of the mobile telephone licenses in 2000.

Source: OECD, Economic Outlook 78, December 2005, Annex Table 27, 28, 29 and 30.

EEAG Report 2006

The functioning of the fiscal rules

- Lower budget deficits than would otherwise have occurred
- But gradually more violations of the rules
  - the Netherlands (2003) are the only example where the rules have *clearly* been followed
  - Breaking-off of the excessive deficit procedures against Germany and France in late 2003
  - **Ten** years of excessive deficits in Greece
  - Too lenient treatment of Portugal in 2004
  - The debt criterion has been neglected
  - The Ecofin Council has not followed the Commission's recommendations on *early warnings* in three cases out of four

Table 6a Breaches of deficit and debt criteria and the excessive deficit (ED) procedures for EU-15 countries, 1999-2005

France	Germany	Greece	Italy	Netherlands	Portugal 1	Portugal 2	UK
Deficits	Deficits	Deficits	Deficits	Deficits	Deficits	Deficits	Deficits
2002: 3.2 2003: 4.2 2004: 3.7 2005: 3.0	2002: 3.7 2003: 3.8 2004: 3.7 2005: 3.3	1999: 3.4 2000: 4.1 2001: 3.6 2002: 4.1 2003: 5.2 2004: 6.1 2005: 4.5	2003: 3.1 2004: 3.1 2005: 3.6	2003: 3.2	2002: 4.4	2005: 6.2	2003/04: 3.2 2004/05: 3.2 2005/06: 3.0
Debt	Debt	Debt	Debt	Debt	Debt	Debt	Debt
2003: 63.9 (+4.9) 2004: 65.6 (+1.7) 2005: 66.2 (+0.6)	2002: 60.9 (+1.5) 2003: 64.2 (+3.3) 2004: 66.0 (+1.8) 2005: 68.0 (+2.0)	2000: 114.0 (+1.7) 2001: 114.8 (+0.8) 2004: 110.5 (+1.2) 2005: 110.5 (±0)			2003: 60.1 (+1.6) 2004: 61.9 (+1.8)	2005: 66.5 (+4.6)	
• Commission report 02/04/03 • Commission opinion and recommendation 07/05/03 • Council decision on ED and recommendation to correct ED by 2004 03/06/03	• Commission report 19/11/02 • Commission opinion and recommendation 08/01/03 • Council decision on ED and recommendation to correct ED by 2004 21/01/03	• Commission report 19/05/04 • Commission opinion and recommendation 24/06/04 • Council decision on ED and recommendation to correct ED by 2005 05/07/04	• Commission report 07/06/05 • Commission opinion and recommendation 29/06/05 • Council decision on ED and recommendation to correct ED by 2007 28/07/05	• Commission report 28/04/04 • Commission opinion and recommendation 19/05/04 • Council decision on ED and recommendation to correct ED by 2005 02/06/04	• Commission report 24/09/02 • Commission opinion and recommendation 16/10/02 • Council decision on ED and recommendation to correct ED by 2003 05/11/02	• Commission report 22/06/05 • Commission opinion and recommendation 20/07/05 • Council decision on ED and recommendation to correct ED by 2008 12/09/05	• Commission report 28/04/0 • Commission report 21/09/0

• Commission judgement on lack of effective action 08/10/03 • Commission recommendation to give notice 21/10/03 • Council conclusions, instead of notice, to correct ED by 2005 25/11/03 • Court of Justice annulment of Council conclusions 13/07/04 • Commission communication on extended deadline until 2005 14/12/04	• Commission judgement on lack of effective action 18/11/03 • Commission recommendation to give notice 18/11/03 • Council conclusions, instead of notice, to correct ED by 2005 25/11/03 • Court of Justice annulment of Council conclusions 13/07/04 • Commission communication on extended deadline until 2005 14/12/04	• Commission judgement on lack of effective action 22/12/04 • Council decision on lack of effective action 18/01/05 • Commission recommendation to give notice 9/02/05 • Council decision to give notice and extend deadline until 2006 17/02/05		• Commission recommendation to close ED procedure 18/05/05	• Commission recommendation to close ED procedure 28/04/04 • Council decision to close ED procedure 11/05/04		

Notes: Deficit and debt figures are in per cent of GDP. Debt figures in parenthesis show the increases from previous year. For the UK, deficit figures re to fiscal years, as the evaluations in the excessive deficit procedure for this country are made on this basis.

The reform of the stability pact

- Economic contents
- Enforcement procedure

Definition of excessive deficit

- Widening of the exceptionality clause in the case of ”a severe economic downturn”
  - ”negative growth”
  - ”accumulated loss of output”
- ”Other relevant factors”
  - ”potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster R&D and innovation”
  - ”fiscal consolidation efforts in good times, debt sustainability, public investment and the quality of public finances”
  - ”any other factors, which in the opinion of the Member State concerned are relevant”:
  - ”budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe”
- But exceptions only if deficits are *close* to three per cent of GDP and *temporary*

Commitments

- Increased budgetary efforts in good times
- Member states with large structural deficits are to reduce them in at a minimum pace of 0.5 per cent of GDP per year
- Greater emphasis on the debt criterion
- But the commitments apply to the soft parts of the pact

Extension of deadlines

- Initial deadline can be set one year later
- Repetion of recommendation and notice

  - one-year extension in both cases

  - ”special circumstances”: ”other relevant factors”

  - condition: ”unexpected adverse events”

Table 9 Theoretically possible scenarios for the excessive deficit procedure in case of non-compliance (time until first fine)

Year	Old pact as originally envisaged and strict application of new pact	Lax application of new pact	Very lax application of new pact	Super-lax application of new pact	Maximum laxity according to new pact
t	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP
t+1	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Excessive deficit exception
t+2	Deadline for correction				Council decision on excessive deficit and recommendation
t+3	First deposit	Extended initial deadline	Extended initial deadline	Extended initial deadline	
t+4	Second deposit	First deposit	Repeated recommendation and new extension of deadline	Repeated recommendation and new extension of deadline	Extended initial deadline
t+5	First deposit converted into fine	Second deposit	First deposit	Repeated notice and further extension of deadline	Repeated recommendation and new extension of deadline
t+6		First deposit is converted into fine	Second deposit	First deposit	Repeated notice and further extension of deadline
t+7			First deposit converted into fine	Second deposit	First deposit
t+8				First deposit converted into fine	Second deposit
t+9					First deposit converted into fine

Note: The table has been constructed under the assumption that a deficit above three per cent of GDP is identified the year after its occurrence. Later identification would lengthen the period before fines should be imposed according to the new rules.

Overall assessment of reform

- Elements that tend to strengthen fiscal discipline apply only to the soft ends of the pact
- Increased scope for discretionary enforcement
- The fundamental enforcement problem has not been addressed but worsened
- Enforcement of more loosely defined rules will command less legitimacy
- The new fiscal framework is *complex, non-transparent and uneforceable*
- *Slow* instead of prompt correction of excessive deficits
- Missed opportunity to combine more flexibility with more credible enforcement
- Demonstration that rules are endogenous and responsive to violations
- Discretionary decision-making has moved to the "constitutional level" as well

The current situation

- 12 out of 25 EU states have excessive deficits
- France,Germany, Greece, Italy, Portugal, and the UK
- Cyprus, Czech Republic,Hungary, Malta, Poland, and Slovak Republic

Deadlines for elimination of excessive deficit

	Deadline	Years with ED	Deficit 2005	Debt 2005
Cyprus	2005	1	-2.4	70.3
Czech Republic	2008	4	-2.6	30.5
France	2004	?	-2.9	66.8
Germany	2007	5	-3.3	67.7
Greece	2006	9	-4.5	107.5
Hungary	2008	4	-6.1	58.4
Italy	2007	4	-4.1	106.4
Malta	2006	2	-3.3	74.7
Poland	2007	3	-2.5	42.5
Portugal	2008	3	-6.0	63.9
Slovakia	2008	4	-2.9	34.5
UK	2006/07	3	-3.6	42.8

Risks ahead

- Wrong stabilisation policy mix
  - tightened monetary policy
  - loose fiscal policy
- A reverse policy mix is desirable
  - demographic pressures
- Short-term improvement of public finances in cyclical upswing
  - but it will be insufficient
- Contagion effects
- Co-ordination failure of monetary and fiscal policy

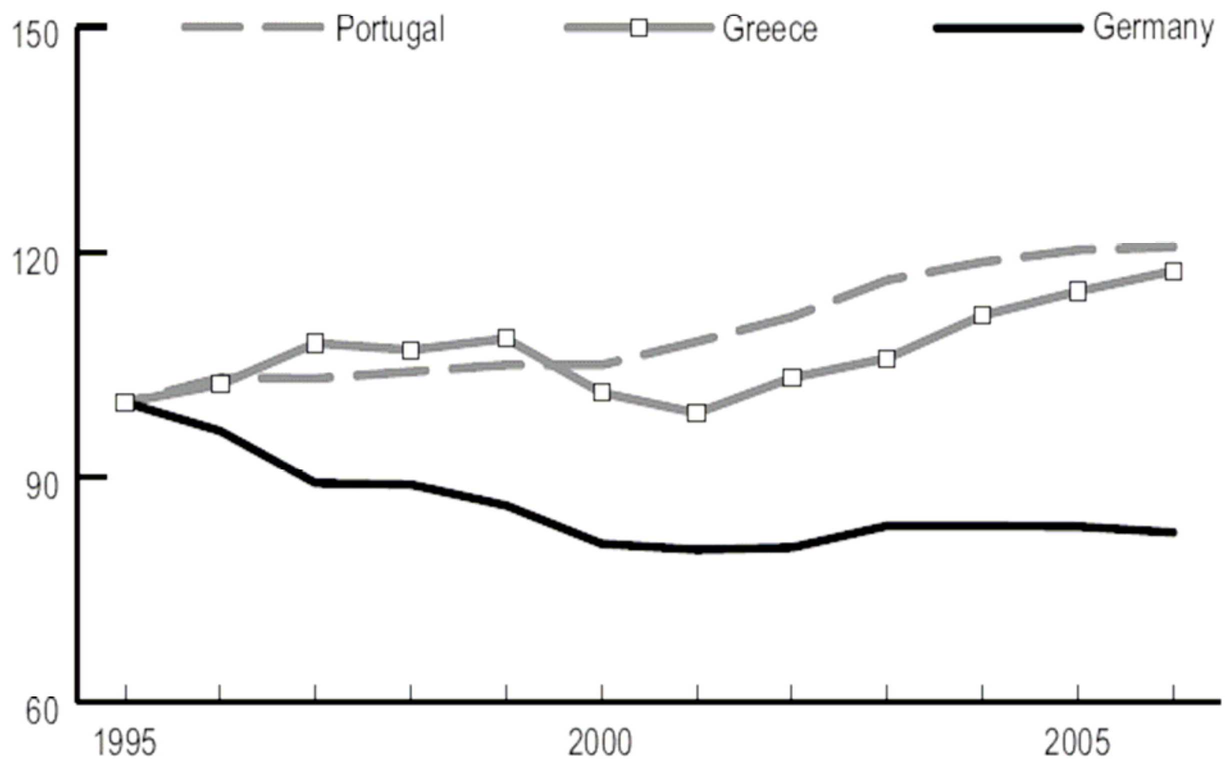
What next?

1. Strict application of new stability pact and additional reform
2. Enhanced fiscal policy co-operation among the fiscally most responsible EU members
3. Stronger national fiscal policy institutions

Strict application of the revised rules

- Set a precedent for the future. But:
  - 2006: tenth year with deficits in excess of the ceiling in Greece
  - extended deadlines for Italy and Portugal
    - how should they manage?
  - 2007 extension for Germany
- Changed attitude of new German government
  - but lax precedent already set
  - no ”unexpected adverse events”
  - consensus with Germany has been sought

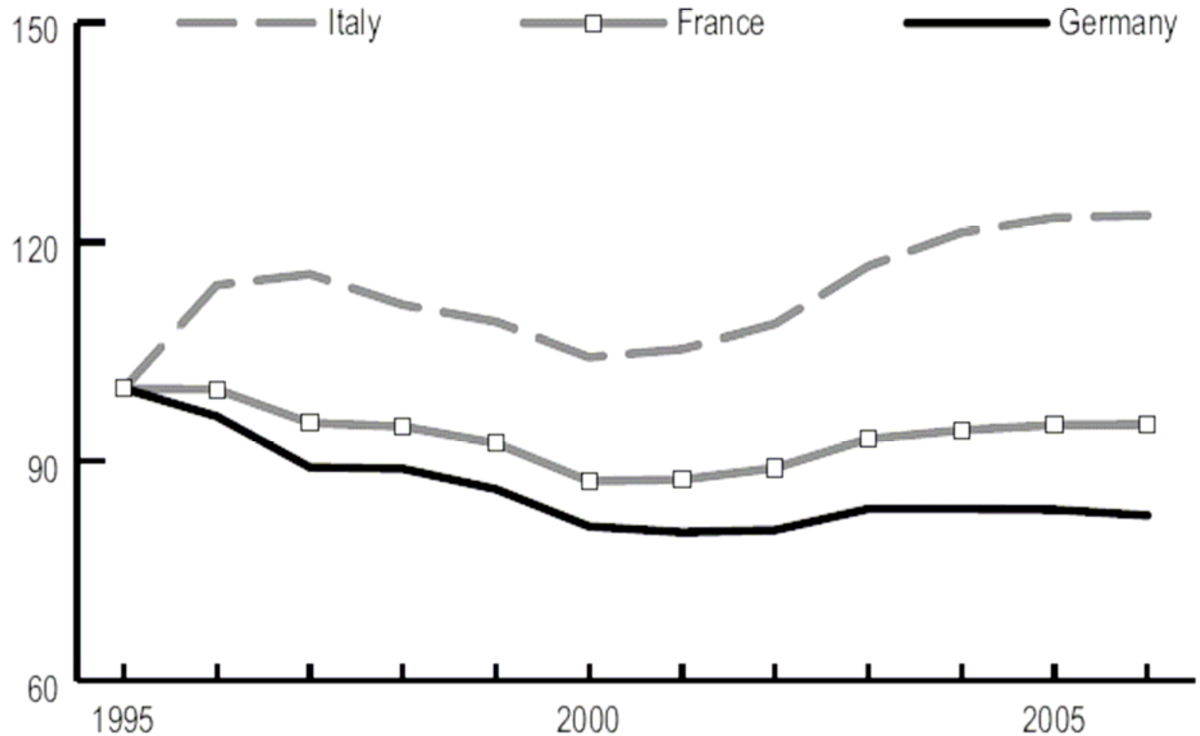
Figure 5a Real exchange rates (relative unit labour costs) for Germany, Greece and Portugal, 1995-2006



Notes: 1995=100. Relative unit labour costs refer to the whole economy. 2005 and 2006 values are estimates using data up to 16 March 2005.

Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

Figure 5b Real exchange rates (relative unit labour costs) for France, Germany and Italy, 1995-2006



Notes: 1995=100. Relative unit labour costs refer to the whole economy. 2005 and 2006 values are estimates using data up to 16 March 2005.

Sources: *Statistical Annex of European Economy*, Autumn 2002 and Spring 2005, European Commission.

Restoration of credibility requires addressing the enforcement problem

- The root of the problem is political decision-making
- Original German proposal was for *automatic sanctions*

<u>Two possibilitities</u>

<u>First-best solution</u>: Depoliticise sanction decisions by moving them to the judicial level of the European Court

<u>Second-best solution</u>: Strengthen the political incentives to actually employ sanctions

Three proposals

1. Countries with excessive deficits should not be allowed to vote in the excessive deficit procedures against other countries (collusion problem)
2. The size of deposits/fines should be reduced (credibility of sanctions)

   - deposits/fines should not be front-loaded
3. Combine pecuniary with non-pecuniary sanctions (legitimacy problem)

   - voting power (?)

Table 8 The size of deposits/fines

Deficit (per cent of GDP)	Deposit/fine (per cent of GDP) Year 1	Subsequent years
3-4	0.3	0.1
4-5	0.4	0.2
5-6	0.5	0.3
6-7	0.5	0.4
7-	0.5	0.5

Co-ordination of monetary and fiscal policy reform

- Higher inflation target for the ECB
  - facilitates real exchange rate adjustments
  - smaller risk of too high real wages because of downward money wag rigidity
  - smaller risk of being caught in liquidity trap in recession
- More stringent fiscal policy framework
- Could the ECB offer an ex-post monetary policy reward as a response to a reestablishment of stronger fiscal rules?

Fiscal policy co-operation among only some EU countries

- Address disconnect between EU and national levels
- *Fiscal sustainability pact*
  - formal *enhanced co-operation*
  - informal co-operation
- Procedural commitments
  - Commission and Council presentations in national parliaments
  - parliamentary hearings
  - formal obligations of governments to respond
- Policy commitments
  - prompt correction of excessive deficits
- Admittance criteria
- The fiscally most responsible member states

Pros and cons

- Set example of fiscal discipline
- Example of flexible integration

- Only concern for reputation but no sanctions
- No tradition of co-operation of small EU states
- Resistance from large EU states?
- Insufficient legitimacy (?)

Stronger national fiscal policy framework

1. Well-defined objectives
   a. budget balance (debt development) over the cycle
   b. expenditures
   c. stabilisation
2. Commitment to transparency
3. Incentives to avoid deviations from objectives

Discretionary countervailing powers in the national decision-making process

- Fiscal policy council
  - independent experts
  - guardian of the fiscal policy objectives determined *ex ante* by the parliament

Various set-ups

- Independent forecasts, policy recommendations and analyses of government budget proposals
  - another player in the market for policy analysis
  - reputation could be built if ample resources
- Oblige government to base budget proposal on the council's forecasts
  - to counteract *optimism bias*
- More direct involvement in decision-making process
  - start annual budget process with council recommendation
  - evaluation of final government proposal
  - formal response of government to the council reports and motivations for deviations
  - open parliamentary hearings
- Larger reputation costs for government of fiscal profligacy

Direct decision-making role of fiscal policy council

- Veto right if budget deficit of government is judged to deviate fundamentally from pre-set objectives of parliament
- The parliament can always override veto

  - new single-majority parliamentary decision

  - new qualified-majority parliamentary decision

  - new parliamentary decision after elections
- If veto stands, the parliament would adjust the planned deficit according to the decision of the council

  - but no influence of the council on individual taxes and expenditures

Highly controversial proposals

- Proposals by ”high status group in dark suits who openly and actively work against democracy with the aim of replacing it with themselves”
- Underlying motive: ”To improve job opportunities”

Allocation between political and techocratic decision-making

- Need for professional competence and processing of information
- Possibilities to specify objectives *ex ante*
- Risks of excessive short-termism of political decisions versus risk that technocrats are guided by idiosyncratic motives rather than politically decided goals
- Complementarity between policies in different fields
- As strong arguments for more technocratic influence in fiscal policy as there is for delegation of monetary policy to independent central banks

Large amount of political control

- Parliament decides the system and can always change it
- Parliament decides fiscal policy objectives governing the work of the council
- Parliament appoints the council
- Parliament can fire the council
- Parliament alone makes all decisions on individual taxes and expenditures
- But democratic gain from clearer distinction between fundamental objectives and execution of policies