FISCAL DISCIPLINE AND FLEXIBILITY IN EMU: THE IMPLEMENTATION OF THE STABILITY AND GROWTH PACT

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Fiscal discipline to safeguard the credibility of the single monetary authority and fiscal flexibility to respond to country-specific shocks are two core principles governing budgetary policy in EMU. The Stability and Growth Pact aims at ensuring the first objective. To comply with the requirements of the pact, EU members need to achieve a ’close to balance or surplus’ position and change their budgetary behaviour in periods of cyclical upturns by refraining from spending the ‘growth dividend’. Past experience shows that fiscal laxity does not buy more effective stabilization. Once EMU countries have achieved their medium-term target, their automatic stabilizers will be able to operate fully, thus helping in smoothing out cyclical fluctuations. The main potential problems in the implementation of the pact may arise in the early years of EMU, during the transition to a balanced budget, in the event of a slow-down in economic activity.

I. INTRODUCTION

Fiscal discipline and flexibility are the main principles governing budgetary policy in a monetary union. Fiscal discipline allows the credibility of monetary policy to strengthen, while flexibility is required to deal with country-specific shocks (European Commission, 1990). The first principle is explicitly imposed by the Maastricht Treaty for membership in Economic and Monetary Union (EMU).

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Over the past years, important consolidation efforts have been undertaken in the countries of the European Union (EU) to meet the Maastricht budgetary criteria. Following a peak of 6.1 per cent of GDP in 1993, the average government deficit in the EU fell steadily in the following years, reaching 2.4 per cent of GDP in 1997. As was emphasized in the European Commission’s Convergence Report (European Commission, 1998a), the scale and composition of these adjustments indicate that they were generally soundly based and therefore unlikely to be easily reversed in the future. In spite of these achievements, budgetary discipline will have to be continued in the coming years and further adjustments will be necessary to comply with the obligations of the Stability and Growth Pact. Moreover, budgetary policy will have to adjust to the new institutional setting, based on a common monetary policy and decentralized fiscal policies.

The pact, which aims to uphold fiscal discipline once in EMU, demands that member states achieve a budgetary position which allows them to respect the Treaty’s deficit criterion, even during periods of unfavourable growth. The pact makes it clear that the 3 per cent of GDP reference value can be breached only temporarily and under exceptional circumstances. The waivers foreseen in the pact are subject to such stringent conditions that the 3 per cent of GDP threshold becomes de facto a strict upper limit for the deficit, which EMU members will want to avoid breaching in order not to be put into excessive deficit and risk incurring sanctions.

Countries participating in the euro-area need to attain a sound fiscal position to face the budgetary consequences of adverse economic developments without having to resort to pro-cyclical behaviour. As spelt out in the Resolution of the European Council on the Stability and Growth Pact, ‘adherence to the objective of sound budgetary positions close to balance or in surplus will allow all member states to deal with normal cyclical fluctuations while keeping the government deficit within the value of 3 per cent of GDP’.

The pact focuses exclusively on the budget balance as the main operational variable to establish and maintain budgetary discipline. Such exclusive attention to the deficit sparked criticism in the policy debate, where it was stressed that the risks of instability in EMU are more likely to be related to the high levels of outstanding debt than to the overshooting of the deficit threshold. With the declaration by the council of finance ministers (Ecofin) of 1 May 1998—which complements the formal package of the pact—however, renewed emphasis is being put on the importance of accelerated debt reduction towards the 60 per cent of GDP reference point, especially in the highly indebted member states.

As the pact becomes fully operational, open issues concerning its implementation need to be addressed. What is a medium-term budgetary position of ‘close to balance or in surplus’?; how much additional adjustment needs to be implemented to achieve this position?; how quickly should the highly indebted countries reduce their debt ratio towards the 60 per cent of GDP reference point?; how should overall budgetary behaviour change to comply with the pact?; will fiscal flexibility be hindered? These questions are examined in this paper. It takes the institutional set-up of the pact as given and explores its implications for the behaviour of budgetary authorities.

The second section of the paper provides a brief overview of the Maastricht fiscal rules and recalls the debate on the initial proposal for a ‘Stability Pact for Europe’ by the German Finance Minister, Theo Waigel. The main provisions of the Stability and Growth Pact, which was adopted by the European Council in June 1997, are also examined in this section as well as the rationale for a common commitment to ensure fiscal discipline in EMU. Section III analyses the ongoing debate on the pact’s implementation and its impact on budgetary policy-making in EMU. The fourth section addresses some of the open policy issues related to the implementation of the pact. The main policy implications are summarized in the concluding section.

II. ENSURING FISCAL DISCIPLINE IN EMU

(i) Fiscal Discipline in the Maastricht Treaty

The requirement of achieving fiscal discipline to join the single currency and of maintaining it once in EMU are at the core of the Maastricht Treaty.
Article 104c of the Treaty states that, in EMU, ‘Member States shall avoid excessive government deficits.’

Compliance with the Treaty’s fiscal discipline requirement is assessed, inter alia, on the basis of the behaviour of the government budget deficit in relation to the reference value of 3 per cent of GDP and by the evolution of the government debt ratio with respect to the 60 per cent of GDP threshold. The deficit criterion is satisfied when the government deficit ratio remains below the 3 per cent of GDP threshold or has fallen substantially and continuously and comes close to that level. All the 11 countries adopting the euro on 1 January 1999 had a deficit at or below the reference value in 1997.

The Treaty allows the 3 per cent ceiling to be exceeded without causing an excessive deficit, but only under a highly restrictive set of conditions. The original cause of the rise of the deficit above the 3 per cent ceiling must be ‘exceptional’, the deficit must, in any case, remain close to this threshold, and must return promptly below it once the initial driving force is over. The range of events not giving rise to an excessive deficit depends on the degree of restriction with which these conditions are interpreted, but the Treaty does not provide any further indications to guide this interpretation.

The government debt ratio has to remain below 60 per cent of GDP or has to be on a clearly downward path towards that level. Government debt is defined as gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government. Data availability and definitional problems as well as the fact that financial instability concerns are usually linked to gross rather than net debt motivated this choice.

When a country is subject to a Council decision on the existence of an excessive deficit, a procedure aimed at correcting this situation is initiated. This procedure includes several steps involving increasing pressure on the member state through recommendations and notice to take effective measures to reduce the deficit. If such correction does not take place, the Maastricht Treaty foresees that sanctions may be applied to countries participating in the euro-area. Among the sanctions cited in the Treaty are non-interest-bearing deposits and fines. The Treaty, however, leaves a certain discretion to the Council on the application and the content of these sanctions and does not set time limits on the various steps of the procedure.

(ii) The Initial Waigel Proposal

A proposal for a ‘Stability Pact for Europe’ was put forward by the German Finance Minister, Theo Waigel, in November 1995. While clearly stating that no renegotiation of the Maastricht criteria for participation in the euro-area was envisaged, Waigel’s pact presented a number of proposals to make fiscal prudence watertight in EMU. In order to achieve this, member states were supposed to enter a voluntary commitment encompassing the following elements:

- setting a medium-term goal of 1 per cent of GDP in ‘normal’ economic conditions, thereby providing a safety margin of 2 percentage points of GDP above this target so that the 3 per cent of GDP deficit limit would not be breached even in economically unfavourable periods;
- granting exceptions to observance of the 3 per cent limit only in extreme circumstances, such as an annual fall in real GDP by at least 2 per cent or a decrease in GDP during four quarters in a row;
- failure to comply with the 3 per cent of GDP threshold would automatically trigger pecuniary sanctions, in the form of non-interest bearing deposits of 0.25 per cent of GDP for each point or share of a point of the budget deficit above the 3 per cent ceiling. This deposit was to be transformed into a fine if an excessive deficit still existed 2 years later.

Other elements of the proposal envisaged a further reduction of the government debt ratio to well below the reference value of 60 per cent of GDP, a limitation of the share of the government sector in the economy by keeping the rate of growth of government expenditure below that of nominal GDP, and the creation of a ‘Stability Council’, composed of the member states participating in the euro-area, which would supervise the strict application of the Stability Pact.
While the aim of ensuring that budgetary discipline would not be only an entry criterion but a permanent feature of EMU was widely shared, a number of these provisions were not retained. First of all, the automaticity of sanctions was deemed to go beyond the provisions of the Treaty, which left a degree of discretion to the European Commission and Ecofin Council in this respect. In addition, it was thought that the proposed sanctions were excessively high and that the discrete jumps in the amount of pecuniary sanctions could give rise to negative threshold effects. Second, constraint on the government debt was considered unnecessary because a sustained budget balance below the 3 per cent of GDP reference value would automatically imply a progressive fall of the government debt ratio to well below the 60 per cent of GDP reference point. A uniform target of 1 per cent of GDP was deemed not to take sufficient account of country-specific requirements and was considered neither necessary nor sufficient to guarantee respect of the 3 per cent ceiling. Third, the lack of any flexibility on the ‘exceptionality’ clause concerning the severity of recessions was considered too harsh. Finally, reducing the share of the government sector in the economy, while probably desirable for purely efficiency reasons, was not accepted as a general rule. The freedom by each country to decide on the split between private- and government-sector activities—in conformity with the so-called subsidiarity principle—and the lack of evident cross-country spill-overs led to this choice.

(iii) After the Negotiations: The Stability and Growth Pact

Negotiations on the pact were conducted during 1996 and the first half of 1997. The politically difficult issue of the ‘exceptional’ conditions under which a breach of the 3 per cent threshold is allowed was settled at the European Council in Dublin in December 1996.

The final package, adopted by the European Council in Amsterdam in June 1997, included a Council Regulation on strengthening the surveillance of budgetary positions—the preventive arm of the pact—and one on speeding up and clarifying the implementation of the excessive deficit procedure—the dissuasive arm. These two legal texts were complemented by two European Council resolutions: the first on the commitments by all the actors to move swiftly in the event of fiscal misbehaviour, and the second on growth and employment.

The core elements of the Stability and Growth Pact include the following.

- Pursuing country-specific ‘medium-term objectives of budgetary positions close to balance or in surplus’, so as to allow member states to respect the 3 per cent ceiling even during economic downturns.
- Defining the meaning of the ‘exceptionality’ condition. This condition recognizes that, in the event of a harsh and persistent recession, the budgetary room for manoeuvre between close-to-balance and a deficit of 3 per cent of GDP may not be sufficient to cushion the negative effects of the shock on economic activity. In particular, this can be called upon if the deficit overshooting takes place in the presence of a severe economic downturn. The latter is considered ‘exceptional’ if there is an annual fall of real GDP of at least 2 per cent. An annual fall of GDP of less than 2 per cent could nevertheless be considered exceptional in the light of further supporting evidence, such as the abruptness of the downturn or the accumulated loss of output relative to past trends. In any event, in evaluating whether the economic downturn is severe, the member states will, as a rule, take an annual fall in real GDP of at least 0.75 per cent as a reference point.
- Defining the meaning of the ‘temporariness’ condition. The excess of the deficit over 3 per cent of GDP will be considered temporary and thus allowed by the pact only insofar as the ‘exceptional’ conditions mentioned above persist. Therefore, the deficit has to move back below the 3 per cent threshold in the year following that during which these ‘exceptional’ circumstances occurred.
- Putting in place an early-warning mechanism, under which member states participating in the euro-zone will have to submit stability programmes, while those not adopting the single...
currency will have to present convergence programmes. The key feature of both types of programmes is the specification of the national medium-term budgetary objectives. The Council will regularly examine both sets of programmes. The Council can issue a recommendation under Article 103(4) of the Treaty urging the member state concerned to take adjustment measures, should significant slippage from the targets set in the programmes be identified. The pact applies to all EU countries but it stops short of imposing sanctions on the non-EMU members.

- **Speeding up the excessive deficit procedure.** As shown in the timetable in the Annex, in order to avoid the imposition of sanctions, the member state which has been put into excessive deficit needs to take immediate action and complete correction of the deficit in the year following its identification. Thus, in order to avoid sanctions, the member state concerned should bring back its deficit below the reference value 2 years after the occurrence of an excessive deficit and 1 year after its identification, unless special circumstances are given. The pact does not specify what these special circumstances are, but it seems to be widely accepted that this clause could be relied upon in case of protracted or very severe recessions.

- **Specifying the scale of sanctions in the event of persistent excessive deficits.** The amount of the non-interest bearing deposit in the first year of application of the sanctions is composed of a fixed component equal to 0.2 per cent of GDP and a variable component equal to one-tenth of the difference between the deficit and the 3 per cent reference value. A ceiling of 0.5 per cent of GDP is set. The fixed component aims at providing an incentive not to incur an excessive deficit, while the variable component represents an incentive to limit the excess over the 3 per cent threshold. In each subsequent year, until the excessive deficit decision is abrogated, only the variable component will be applied. As a rule, a deposit is to be converted into a fine after 2 years if the excessive deficit persists. If no action is taken to correct the excessive deficit, sanctions can be imposed within the calendar year in which the decision on the existence of the excessive deficit is taken.

Not all the uncertainties surrounding the implementation of the excessive deficit procedure have been clarified by the pact.

First, the pact does not define the meaning of the ‘closeness’ condition. So far, there has been no case of a member state having a deficit above but sufficiently close to the 3 per cent of GDP reference point for it to be put out of excessive deficit. A *de facto* interpretation of the ‘closeness’ condition based on the abrogation of an excessive deficit decision is thus not available either. As the pact has given a sufficiently stringent interpretation of the ‘exceptionality’ and ‘temporariness’ conditions, a broader definition of the ‘closeness’ condition would not produce significantly different results with respect to the decision on the existence of an excessive deficit (Buti et al., 1997).

Second, it is conceivable that in a situation of recession a member state with a relatively low government debt would experience a rise in its debt ratio, even though its deficit remained below the 3 per cent threshold. Would such a member state be put into excessive deficit and be subject to sanctions? Up to now there is no precedent of a country being put into excessive deficit because of a violation of the debt criterion alone. There are no special provisions in the Treaty— as is the case for the deficit—allowing for an exceptional rise in the debt ratio during severe economic slow-downs. It is also not clear whether sanctions would be applied if a decision on the existence of an excessive deficit was taken in such a situation. The sanctions spelt out in the pact only apply when the excessive deficit results from non-compliance with the deficit criterion. As with other issues, the Council will have to make a decision on a case-by-case basis, using the discretion allowed by the Treaty.

(iv) **The Ecofin Council Declaration of 1 May 1998**

Further specifications concerning the implementation of the pact during the period at the start of EMU are given in the formal declaration—based again on
a proposal by the German Finance Minister, Theo Waigel—that was adopted by the Ecofin Council during the ‘EMU weekend’ at the beginning of May 1998, when the decision on the number of countries participating in the euro-area was taken.

In this declaration, member states participating in the euro-area took up the following additional commitments:

- to reinforce budgetary consolidation in order to reach the medium-term objective of government financial positions close to balance or in surplus, if economic conditions developed better than expected;

- for the highly indebted member states, to reduce government debt ratios rapidly. To achieve this, appropriate levels of primary surplus will be maintained and other measures to reduce gross debt put in place. In addition, debt management strategies will be implemented to reduce the vulnerability of budgets to fluctuations in interest rates.

This declaration highlights two areas of concern. First, following the spirit of the pact, any ‘growth dividend’ should not be eaten up by a loosening of the budgetary stance, but should preferably be used to improve the actual budget balance, and budgetary consolidation should be stepped up during periods of high growth. This approach is to be followed especially in the transition period until the medium-term budgetary targets of ‘close to balance or in surplus’ have been reached. Second, renewed pressure is being put on the highly indebted member states rapidly to bring down their debt ratios. This implies that the Treaty’s debt criterion could be enforced more strictly than has been the case up to now. When setting their medium-term budgetary targets, the highly indebted member states would have to ensure that they not only satisfy the Treaty’s deficit criterion, but also that their debt ratio is brought down at a sufficient speed.

(v) Was There a Need to Supplement Maastricht?

Given the Maastricht fiscal rules—which, in the eyes of many scholars and policy-makers appear already very strict—why did EU countries feel obliged to undertake a further commitment on budgetary discipline?

As explicitly stated in the initial proposal by Theo Waigel, clarifying and tightening up the Treaty provisions on the excessive deficit procedure was the main objective of the pact. Several reasons for a Stability Pact in EMU have been put forward in the debate. These arguments boil down to three not-mutually-exclusive explanations. A formal commitment to a tight interpretation of the excessive deficit procedure of the Treaty would be helpful in:

- Underpinning the credibility of the single monetary authority (Ackrill and Garrat, 1997; Artis and Winkler, 1997; Eichengreen and Wyplosz, 1998). Without strong fiscal rules, the legal independence of the European Central Bank (ECB) may turn out to be an empty shell because of pressure by high-debt countries for ex-ante bailout (refraining from raising interest rates in conditions of inflationary tensions) or ex-post bail-out (debt relief through unanticipated inflation). As stated by McKinnon (1997, p. 228), ‘once each European finance minister no longer has the central-bank support for debt management... very high nominal debts would become unsustainable unless the capital markets could see some tightly specified program for debt reduction already in place’. The Stability Pact aims to fulfil this role. However, as noted by Artis and Winkler (1997) and Begg et al. (1997), if the pact leads to an unduly tight fiscal stance in one or more countries, pressure may mount on the ECB to deliver a monetary offsetting. This is unlikely to be the case once the medium-term target has been achieved, but it may cause a potential problem during the transition period.

- Tying the hands of politicians to counter a domestic deficit bias (Beetsma and Uhlig, 1997; European Commission, 1998b). The pact can be interpreted as a ‘commitment technology’ to ensure fiscal prudence, since governments may feel less inclined to preserve fiscal rectitude, as they individually face a less steep interest rate schedule in a monetary union than under flexible exchange rates.
The Maastricht public finance rules—specific numerical targets *cum* a precise calendar to achieve them—provided a strong incentive to pursue budgetary consolidation in the run-up to EMU. The credible threat of exclusion from the first wave of countries moving to the euro was considered a heavy penalty, especially for member states traditionally on the frontline of European integration.

However, once in EMU, incentives to pursue budgetary retrenchment may weaken substantially as an equivalently powerful penalty—expulsion from the euro-zone—is not foreseen by the Treaty. The ‘temptation’ to relax budgetary efforts may be further increased by the need to draw breath after the sharp acceleration in consolidation in 1997 and a need to move to the ‘next stage’ of policy-making in which governments care more about growth and employment than financial rigour. The pact, by increasing multilateral surveillance of budgetary developments, speeding up the excessive deficit procedure, and specifying the application and type of sanctions, aims at countering such opportunistic behaviour.

- Achieving a *balanced policy mix* at the outset of EMU. From a short-term perspective, a common drive towards further fiscal adjustment will create the conditions to allow the ECB to deliver the desirable offsetting monetary response. As pointed out by Allsopp and Vines (1996, p. 99), ‘Only if all [countries] act together will the monetary offset to fiscal tightening be likely to eventuate. Thus, participating governments will not only want to commit themselves, they will want to impose commitment on others as well.’ Without such a common undertaking, the likelihood of an over-restrictive monetary stance would increase, also in view of the credibility-building strategy of the newly created ECB.

All in all, the pact has reinforced the disciplinary principles of the Treaty, thereby strengthening ‘negative’ coordination aimed at preventing fiscal misbehaviour. Like the Treaty itself, the pact pays less attention to the ‘positive’ coordination of budgetary policies among member states, aimed at achieving the appropriate fiscal stance for EMU as a whole.

### III. Changes in Budgetary Behaviour to Comply with the Pact

(i) What is ‘Close to Balance or in Surplus’?

As stated above, member states should set their medium-term budgetary positions in such a way that they allow the provisions of the Stability and Growth Pact to be respected. The pact focuses exclusively on government deficit and does not address the issue of government debt. The concern of ensuring the controllability of the target variable was at the root of this choice. From a theoretical standpoint, a deficit rule is important to underpin the ‘functional’, as opposed to the ‘legal’, independence of the central bank: as argued by Canzoneri and Diba (1996), without a credible deficit criterion, the central bank would not be able to keep control of the price level, which would have to adjust in order to ensure public finance solvency.

Under a neutral discretionary policy, member states would have to aim—as a minimum—for a budgetary position which allows the automatic stabilizers to operate fully without breaching the 3 per cent of GDP ceiling. The budgetary position targeted by the member states in ‘normal’ economic conditions corresponds to the budget balance corrected for the influence of cyclical fluctuations in economic activity.

Unlike the numerical rules of the Maastricht Treaty—which set a common upper limit for the government deficit for all member states—the pact introduces an element of country-specificity. The pact *de facto* relies on the concept of the cyclically adjusted budget balance, a measure considered by several commentators as a more appropriate policy target than the actual deficit. As pointed out by Artis and Winkler (1997, p. 40), ‘the 3 per cent ceiling on the actual deficit induces behaviour not much different from a target on structural deficits. The main difference is that countries can choose their target structural deficit for themselves, i.e. the optimal size of their ‘cushion’ depending on their own preferences’.

In identifying a ‘safe’ medium-term budgetary position, the size and volatility of the budget’s cyclical
component need to be examined. These are determined by the size and volatility of cyclical fluctuations in output as well as by the sensitivity of the budget to the cycle.

It is still uncertain what effect the move to the EMU-regime will have on the cyclical behaviour of the EU economies. As country-specific policy-induced shocks are likely to decrease in EMU, it can be expected that cyclical variations will be reduced and will become more similar between member states (European Commission, 1998b). However, as monetary policy will be geared towards the economic conditions prevailing in the euro-area as a whole, and since budgetary policy will remain less effective in the more open economies of the smaller member states, the economies of the small peripheral member states could still exhibit a more pronounced variability than those of the large countries.

It is also unclear whether the sensitivity of budget balances to the cycle will change significantly once in EMU. While the ongoing reduction in the weight of the government sector in the economy may reduce the budget’s cyclical sensitivity, such an effect will not take place overnight.

The current estimates used in the Commission services’ cyclical adjustment method indicate that, among the EMU countries, the highest budgetary sensitivity to the cycle is found in the Netherlands (0.8, which means that each deterioration in the output gap by 1 percentage point of trend GDP increases the government deficit by 0.8 percentage points of GDP), followed by Finland (0.7). All the other EMU countries have a sensitivity between 0.5 and 0.6. Outside the euro-area, Sweden and Greece have the highest and lowest sensitivity (0.9 and 0.4, respectively). Budgetary receipts are much more sensitive to cyclical fluctuations in economic activity than expenditure, owing to the importance of the tax share in the economy and to the progressivity of the tax system. Divergences in the cyclical sensitivity of revenue among member states are due to differences in tax rates and tax structures. Government transfers to households to cover costs related to unemployment are the only spending category which is deemed to react automatically to cyclical variations on the expenditure side. Other categories of government spending are considered to remain unaffected. Depending on the transfer system in place, the cyclical sensitivity of government spending may also vary significantly among member states.

If it is assumed that, in line with historical experience, the largest negative output gap that could occur once member states are in EMU amounts to 4 per cent of trend GDP and that the sensitivity of the budget to the cycle will remain broadly unchanged in the coming years, then most of the countries would have to aim for an underlying budgetary position of between 0 per cent and 1 per cent of GDP. The Netherlands and, outside EMU, Sweden, whose budgets have a higher sensitivity to the cycle, would need a small surplus.

If countries want to pursue an active counter-cyclical budgetary policy in addition to letting the automatic stabilizers play, a supplementary safety margin around the medium-term budgetary positions would need to be ensured. Additional room for manoeuvre would be created by setting the budgetary targets at a more ambitious level than would be the case if no such active budgetary policy was pursued. An additional safety margin may also be required to cope with unforeseen variability arising from factors such as unexplained tax shortfalls, more rapid expansion of spending on entitlement programmes than expected, etc.

The results of these simple calculations are in line with those of other studies (for example, Masson, 1996; Artus, 1997) and lie somewhat below those of

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2 The Commission services’ cyclical adjustment method is described in European Commission (1995). The Hodrick–Prescott trend estimation method is used for the calculation of output gaps. The negative output gaps produced by this method are slightly smaller than those given by other methods, such as, for example, the production function approach. The OECD and the IMF use a Cobb–Douglas production function for the estimation of potential output. The parameter estimates for the sensitivity of budget balances to cyclical fluctuations used in the Commission services’ method are very close to those computed by these organizations.

3 The unweighted average of the lowest negative output gaps in EU member states over the period 1960–97 is just above 4 per cent of trend GDP. Indicators for country-specific cyclical fluctuations, such as the average volatility measured by the standard deviation or the largest negative gap recorded over the past decades, could also have been used for the calculations. The results obtained with these alternative calculations are broadly similar to those given in this paper.
the OECD, which recommends that EU member states set their medium-term budgetary targets at 1 per cent to 1½ per cent of GDP (OECD, 1997). In a retrospective application of the pact to the post-war period, Buti et al. (1997) find that a cyclically adjusted balanced budget would have allowed an excessive deficit to be fended off in 19 out of the 24 cases of recessions entailing a fall in real GDP by at least 0.75 per cent. In the cases where an excessive deficit occurred, there was a prolonged recession with real GDP falling for at least two consecutive years. Thus, a cyclically adjusted balanced budget allows countries to avoid excessive deficits during 1-year slow-downs, but not always during protracted recessions.

While all EMU countries will have to respect the close-to-balance rule, it can be argued that, in addition, high-debt countries should ensure a sufficiently fast reduction in their debt ratio. Low-debt members, as well as the ECB, may have strong incentives to push for a high speed of debt reduction. Such an additional condition may require that the high-debt member states would have to go beyond the budgetary targets these countries would need simply to satisfy the deficit criterion.

Finally, while the need to establish sufficient room for manoeuvre to allow automatic stabilizers to work is an important concern in setting medium-term targets, other elements also play a role. For instance, a more ambitious budgetary position may be required to face the budget burden of future demographic developments. As shown by Franco and Munzi (1997), at constant policies over the 1997–2030 period, the ageing of population would increase the share to GDP of primary expenditure by as much as 6–7 percentage points in Germany and around 5 points in Belgium and Italy. The achievement of a balanced budget over the next few years would allow governments to meet the worsening of the demographic situation after the year 2010—when the baby-boom generation will retire—with smaller government debts. The ensuing reduction in interest payments would offset part of the likely increase in pension and health expenditure. Taking these developments into account, the IMF is of the opinion that member states should aim for a medium-term position of balanced budget (IMF, 1998). 4

To be in line with the pact, EMU countries should implement the structural measures needed to achieve these budgetary targets over the coming few years. Will this further consolidation entail negative demand effects? On the one hand, it can be argued that the conditions required to trigger so-called non-Keynesian effects of fiscal retrenchments (e.g. a clear perception of debt unsustainability) are fading precisely because of the success of Maastricht-induced convergence. On the other hand, the additional budgetary adjustment is overall modest and much smaller than the retrenchment undertaken to reach the 3 per cent target. Starting from the budgetary positions achieved in 1997, the 11 EMU members need to make a further discretionary adjustment amounting, on average, to around 1 per cent of GDP. Outside EMU, the countries needing the highest retrenchment are Greece and the UK (amounting to around 2 per cent of GDP). Furthermore, as argued above, a decisive move towards the ‘close-to-balance’ position in an environment of price stability would help the ECB to avoid a restrictive stance of monetary policy, thereby preventing EMU from falling into the ‘deflationary trap’ signalled by Allsopp and Vines (1996).

(ii) Budgetary Behaviour over the Cycle

How would member states’ budgetary behaviour have to change in order to comply with the requirements of the pact? Would the pact have helped member states to avoid past policy mistakes?

Figure 1 presents a simplified illustration of budgetary behaviour compatible with the Stability and Growth Pact. In this figure, the overall budget balance and its cyclical and discretionary components are pictured against the output gap. Here it is assumed that the government maintains a balanced budget position when the output gap is zero. The figure is drawn by assuming a neutral discretionary policy and a cyclical sensitivity of the budget of 0.5, which, according to the Commission services’ cal-

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4 De Grauwe (1998) points out that maintaining a balanced budget over the cycle would eventually lead to the complete reabsorption of government debt. This prospect may not be desirable, because, in an uncertain environment, there is a (possibly growing) demand for financial instruments carrying a low risk, as is typical of government securities. However, this concern is only relevant in the very long run and, as such, it should not be overrated.
Under the assumption of a ‘normal’ growth of nominal GDP of 4.5 per cent, a balanced budget would make it possible to bring down a debt of 100 per cent of GDP to below the 60 per cent reference value in 12 years. Estimates with the Commission services’ QUEST model show that the stabilizing impact of the type of budgetary behaviour pictured in Figure 1—i.e. simply letting the automatic stabilizers work to cushion cyclical fluctuations—lies around 30 per cent for the EU as a whole (European Commission, 1998b). These estimates are broadly in line with those of other studies (for example, OECD, 1993).

How does the actual budgetary behaviour of EU countries compare to that sketched out in Figure 1?

There is growing evidence that budgetary imbalances accumulated over the past two decades increasingly constrained EU countries in the use of fiscal policy as a stabilization instrument. Furthermore, actual deficits were prevented from coming down during periods of economic expansion owing to pro-cyclical budgetary relaxation policies (Mélitz, 1997; European Commission, 1998b). While such behaviour prevailed on average in the EU, not all EU countries found themselves in such a position. In Figure 2, the actual and cyclically adjusted balances for high- and low-debt EU countries are set out against their output gaps over the period 1970–90, i.e. the period before fiscal consolidation was undertaken in the run-up to EMU. A country is classified as belonging to either the high-debt or low-debt group depending on whether its government debt was situated above or below the EU average during each year of the 1970–90 period.5

Figure 2 shows that low-debt countries seem to have incorporated ante litteram the logic of the pact. In particular, they have kept their budgets close to a balanced position during periods of ‘normal’ economic conditions. Moreover, these countries conducted a broadly neutral discretionary policy in ‘good’ periods, thereby letting automatic stabilizers work and eventually moving into surplus. Finally, they did not allow their budgets to get out of hand during periods of economic slow-down, but

5 As the relative debt position of countries vis-à-vis the EU average is examined, member states can switch group during the period if their behaviour changes. Germany, Spain, France, Luxembourg, and Finland always belong to the low-debt group, while Belgium, Ireland, Italy, and The Netherlands are always classified as high-debt countries. The other countries switch position during the period. Similar results to those presented in Figure 2 are obtained when the countries that switch groups are not taken into account in the analysis.
instead capped their overall deficit at 3 per cent of GDP during such periods.

The high-debt countries, on the contrary, were a long way from the type of budgetary behaviour implied by the pact. These countries maintained deficits of around 6 per cent of GDP during periods of ‘normal’ economic growth and kept their deficits unchanged at this level even during expansionary periods with positive output gaps, by implementing pro-cyclical discretionary policies. A part of the gap in the overall deficit between high-debt and low-debt countries is of course explained by the difference in the interest burden. However, qualitatively similar conclusions are obtained when the analysis is carried out in terms of the net-of-interest (primary) balance.

IV. LIVING WITH THE PACT: POLICY ISSUES

(i) Different Preferences for the Pace of Consolidation

While basically agreeing on the need to follow prudent fiscal policies, EMU members may have a different attitude towards the pace of further fiscal consolidation. The simple model of the Barro–Gordon type in Box 1, which builds on De Grauwe (1996), helps illustrate such potential problems.

Incentives to slow down the efforts of budgetary adjustment may be strong in high-debt countries, which have in recent years attained historically high levels of primary surpluses. Therefore, the objective of a speedy convergence towards the 60 per cent debt level—which the Ecofin Council declaration alludes to—may run into difficulties. On the other hand, low-debt countries may be interested in a fast reabsorption of the debt in order to bring it below the 60 per cent ceiling and thus be let off the ‘debt hook’. They are also interested in fast debt reduction by high-debt countries in order to lessen risks of financial instability and bail-out pressures.

Not only may member states have different preferences regarding the pace of debt reduction in the early years of EMU, but the game is made more complex by the presence of the newly created ECB. Indeed, the end result may well depend on the position of the single monetary authority. The latter may be torn between two conflicting objectives: allowing for a ‘reasonable’ speed of debt reduction so as to prevent high-debt countries running against their ‘maximum politically feasible primary surplus’ (as defined by Blanchard, 1984), thereby pressing for an inflation rate incompatible with the price-stability mandate of the ECB, and pushing for a speedy decline in the stocks of debt to tune down possible risks of financial instability and reduce the pressure for ex-ante bail-out. On balance, the latter
Box 1: Political Feasibility of Budgetary Retrenchment

Let us start from a simplified interpretation of the Maastricht debt rule:

\[ \dot{b} \leq \gamma (60 - b) \]  

where \( b \) is the debt-to-GDP ratio and \( \gamma \) is the agreed-upon minimum speed of reduction of the debt towards the 60 per cent reference value. If (1) is satisfied, the debt will be considered as ‘sufficiently diminishing and approaching the reference value at a satisfactory pace’ (article 104c(2) of the Treaty).

The familiar expression of the government budget constraint is written as follows:

\[ \dot{b} = -s + [(r + \pi^c) - (y + \pi)]b - (y + \pi)m \]  

where \( s \) is the primary surplus, \( r \) is the real rate of interest, \( \pi \) is the inflation rate, \( y \) is real GDP growth and \( m \) is the inverse of money velocity. Assuming that \( r \) and \( y \) are given exogenously, we can derive the short-run and long-run conditions (in the latter case, inflation expectations are realized) for which the above debt rule is satisfied. If the government dislikes both inflation and primary surpluses (and minimizes a quadratic loss function of the usual type), it is easy to show that the equilibrium values of the primary surplus, \( s^* \), and of inflation, \( \pi^* \), are a positive function of the initial debt stock, \( b \), and of the speed of debt convergence, \( \gamma \).

The short-run and long-run equilibrium conditions are pictured in Figure 3, which presents the case of a low- and a high-debt country. The line depicting the short-run condition is less steep than the long one and it is flatter the higher the stock of debt.\(^6\)

The higher the level of debt, the higher is the likelihood that the required primary surplus exceeds its ‘maximum politically feasible’ level. In such a case, the rate of inflation will have to be higher (point B in Figure 3). This, however, may well violate another political feasibility condition, namely that of price stability in EMU. Therefore, a high-debt country may fall outside the politically feasible area \((0_{s_{\text{MAX}}}A_{\pi_{\text{MAX}}})\): once pushed against its maximum politically feasible primary surplus, a country may require too high an inflation rate thereby violating also the price stability condition. Under such conditions, if the ECB sticks to its cards, the country in question may press strongly for a more gradual convergence towards the debt target: a lower \( \gamma \) would reduce both equilibrium values of primary surplus and inflation.

Summing up, this simple model points to two important conclusions: it helps explain the reluctance by low-inflation countries and the (conservative) central bank to allow high-debt countries into the monetary union; it signals that if the latter, in spite of this resistance, become members of the monetary union, then maintaining low inflation may require a not-too-fast pace of debt consolidation.

\( ^6 \) As in De Grauwe (1996), if seigniorage revenue, \((y + \pi)m\), in equation (2) is disregarded, the long-run condition becomes vertical. Its position, however, will still depend on the size of the debt, so the above conclusions remain unaffected.

\( ^7 \) The Ecofin Council declaration implicitly points to the need to lengthen the maturity of the debt, especially in high-debt countries. This may signal that concerns for ex-ante bail-out are stronger than those for ex-post bail-out.

(ii) Will the Pact Limit the Flexibility of Fiscal Policy?

It is widely recognized that forsaking the nominal exchange rate as an adjustment tool increases the

\[ \]
role of fiscal policy in stabilizing the cycle. As spelt out above, the pact stipulates that, during periods of economic slow-down, the budget could go into deficit but should still remain below the 3 per cent threshold.

Will the ‘hardening’ of the 3 per cent ceiling, as argued by some, necessarily reduce the flexibility of fiscal policies? Does the pact over-emphasize fiscal discipline at the cost of losing flexibility in the conduct of budgetary policy (for example, Eichengreen, 1996; Eichengreen and Wyplosz, 1998)?

If EMU members optimize *ex ante* by setting a suitable target for their structural balance and let automatic stabilizers work in both ‘good’ and ‘bad’ periods, the 3 per cent constraint of the pact will not bite. Once the steady state of a budgetary position ‘close to balance or in surplus’ is reached, the margins around this target should provide sufficient leeway for the automatic stabilizers to operate fully. Thus, contrary to strict balanced-budget rules such as those enforced in several US states, the pact allows the automatic stabilizers to operate and in this way to contribute to the stabilization of cyclical fluctuations in economic activity.

Furthermore, it can be argued that achieving sound budgetary positions, as required by the pact, is a precondition to ‘free’ fiscal policies from the burden of high public-finance imbalances, which hampered their use for stabilization purposes. Fiscal laxity does not buy more effective stabilization. On the contrary, over the past decades, the high-debt countries have increasingly lost the room for their automatic stabilizers to operate.

Recent empirical evidence underpins such conclusion. As shown in Buti et al. (1997), during periods of severe recession (defined as entailing a fall in real GDP by at least 0.75 per cent), countries with deficit and debt ratios above the EU average were forced to tighten their fiscal stance by reducing their structural primary deficits by 1.2 percentage points of GDP. Retrenchment policies aimed at preventing a worsening of the budgetary situation were adopted, especially during protracted recession episodes. On the other hand, member states with low fiscal imbalances undertook relaxation policies by increasing their structural primary deficits by 0.8 percentage points on average. Inspection of Figure 2 above lends support to such conclusion. The area under the actual deficit curve for negative output gaps is almost twice as large in the case of low-debt countries as for high-debt countries. This seems to indicate that the latter used only half the room for manoeuvre for cyclical stabilization during recessions compared to that available to the low-debt countries.
Therefore, the potential conflict between discipline and flexibility would only occur during the transition period when budget balances are still relatively close to the 3 per cent threshold. In the event of a recession during the early years of EMU, pro-cyclical fiscal policies would have to be implemented to prevent countries moving into excessive deficit. However, the costs of such a one-time pro-cyclical action during the transition period to keep the government budget on track would have to be weighed against those arising from the loss of credibility due to a loose implementation of the pact. Given their systemic nature, it can be argued that the latter outweigh the former.

(iii) Will Government Investment be Reduced?

The obligation for member states under the pact to maintain budgetary positions which are close to balance or in surplus implies that governments will have to fund the bulk of capital expenditure out of current revenues. Debt finance will no longer be available to smooth the burden of investment projects over the generations of taxpayers receiving the services of the investment goods. The choice between tax and deficit financing of government investment thus affects the distribution of welfare across generations.

Assuming a smooth flow of government investment in any period, the difference between tax and deficit finance concerns only the welfare of the generations alive when the flow starts: under tax finance they pay for projects from which they will only partly benefit. However, if the smooth-flow hypothesis is dropped, every time a large public project is implemented, the generations tax-financing it will suffer a loss to the benefit of future generations.

The transition from debt to tax financing of government investment is likely to exert an additional negative effect on investment decisions. During the transition period, current generations will have to pay fully for new projects while also paying the interest due for debts incurred in the past. Because of these interest expenditures on the accumulated debt, for any given level of government investment a balanced budget entails a larger gap between tax revenues and current government expenditure on services and transfers to the present generation. The opportunity cost of funds devoted to investment is thus higher. As a result, there may be a significant risk of a squeeze in government investment. The issues arising in this context are analogous to those arising during the transition from pay-as-you-go to funded pension systems (Balassone and Franco, 1998).

Unless complete altruism between the different generations and a smooth flow of investment are assumed—in which case tax and debt financing of government investment are equivalent in the steady state—a bias towards current expenditure will be present. As a result, tax financing may reduce government investment, with undesirable effects on growth and employment.

The Treaty implicitly refers to the notion of a ‘golden rule’ by stating that in its report initiating the excessive deficit procedure, the Commission needs to take into account ‘whether the government deficit exceeds government investment expenditure’. There is evidence that government investment remains higher under a ‘golden rule’ than under stringent balanced-budget restrictions. Poterba (1995) examined the institutional variation across US states and suggests that government investment may be lower under a deficit ceiling than under a ‘golden rule’. He finds that US states that maintain separate budgets for capital and current expenditures tend to spend more on public capital than states using unified budgets. He also finds that states that borrow to finance investment have a higher level of both capital and current expenditures than states that do not.

However, it can be questioned whether a fully-fledged ‘golden rule’ allowing EMU members to run deficits up to the amount of their investment expenditure would have represented a feasible alternative to the balanced-budget obligation of the pact.

A satisfactory implementation of such a rule raises several difficulties. Since the ‘golden rule’ is implicitly based on a dual budget system, i.e. on splitting the budget into a current and a capital section, governments would have strong incentives to classify current expenditure as capital spending. As a result, budgetary positions would become even more difficult to monitor than is currently the case. Moreover, as stressed by Buiter et al. (1993), to the extent that the full social returns of public invest-
ment are not appropriated by the government, excessive borrowing may arise. Finally, the division of the budget into current and capital accounts tends to reduce budgetary flexibility and hamper the conduct of stabilization policies. In the EMU budgetary framework, the ‘golden rule’ may thus be inconsistent with the achievement of the twin objectives of ensuring sufficient room for stabilization policies and attaining a sound fiscal stance.

There are several ways to minimize the negative effects of the loss of inter-temporal smoothing of investment decisions: the selection process for investment projects could be improved, the share of resources devoted to current primary spending should be controlled tightly as increases in current spending would further reduce the scope for government investment and a safeguard clause could also be introduced in the budgetary process to ensure that expenditure cuts are not concentrated on capital outlays. Moreover, the currently ongoing shift towards the private financing and operation of public infrastructure investments is likely to continue in coming years and should partially counter-balance the reduction of government investment expenditure.

V. CONCLUSIONS

Fiscal discipline is one of the major building blocks of EMU. The Stability and Growth Pact spells out the conditions underpinning the ‘culture of stability’ underlying EMU. This paper has reviewed the main features of the pact and some of the open issues concerning its implementation.

While the pact has set up an elaborate mechanism to monitor and, if need be, sanction fiscal misbehaviour in EMU, questions on its effective enforcement remain at the centre of the current policy debate. A number of commentators have expressed doubts about the alleged benefits of the pact. They admit that the pact may partly appease fiscal discipline worries but argue that this is achieved at the cost of limiting budgetary flexibility at a time when this is precisely what is needed most. In addition, other critics have argued that governments in the euro-area need to tackle the real problems hampering the functioning of EMU, namely the structural rigidities of European labour markets, instead of pursuing further fiscal consolidation.

While recognizing the legitimacy of these concerns and acknowledging the existence of several uncertainties surrounding the practical operation of the pact, this paper takes a different view. We argue that fiscal discipline and flexibility are complementary and interdependent features of budgetary behaviour in EMU. Once EU countries have attained a budgetary position of ‘close to balance or in surplus’ and are operating at ‘cruising speed’ under the pact, there will be sufficient room for their automatic stabilizers to operate fully. The paper argues, on the basis of an analysis of past fiscal behaviour, that sound budgetary positions in ‘normal’ times are necessary to create room for the automatic stabilizers to work in ‘bad’ times. It can also be argued, though this line of reasoning has not been pursued in the present paper, that the effectiveness of budgetary policy is higher in a situation of low fiscal imbalances. The reaction of the financial markets to a budgetary relaxation will be less pronounced when the starting point is a sound budgetary position: in such a case, the appearance of a risk premium on interest rates is less likely and this in turn will limit the crowding-out effects. Therefore, sticking to the pact will eventually create more room for fiscal stabilization. However, problems could arise in the event of a slowdown in economic activity in the early years of EMU when countries will still have deficits close to the 3 per cent ceiling. These risks would need to be taken into account in the implementation of the pact.

Although doubts have been expressed about the effective application of sanctions, there is widespread agreement that the 3 per cent of GDP reference value has become a ‘hard’ ceiling for the government deficit. All players in the game have an interest in avoiding a situation where the commonly agreed rules of the pact would be violated. Given the efforts that were undertaken during the past years to meet the 3 per cent reference point, governments will want to avoid being seen—both by the markets and their national constituencies—as breaching this ceiling again once in EMU. Moreover, multilateral surveillance of national budgetary policies will be stepped up under the pact, with the European Commission, the Ecofin Council, and the ECB each playing its role in this process. Pressure will be exerted on the errant governments at the first sign that budgetary positions are deviating from the path
set out in their national stability programmes. The high-debt countries in particular will feel the pressure resulting from the constant monitoring of their budgetary behaviour as well as from being singled out against the ‘virtuous’ countries.

A challenge for this multilateral surveillance mechanism is to induce member states to change their budgetary behaviour in ‘good’ times, even though the pact does not explicitly reward such behaviour. Another challenge is triggering the right composition of the adjustment between increased revenue and cuts in current expenditure, the latter being preferable for most countries.

The pact—in particular the provisions concerning the assessment of the medium-term targets set in the national stability programmes, the close monitoring of budgetary behaviour, and the early-warning system—is conceived to consolidate the change in budgetary behaviour brought about in the run-up to monetary union. The procedural reforms in national budgetary processes and institutions that have accompanied the retrenchment efforts in the recent past will complement the ‘commitment architecture’ of the pact and help sustain budgetary prudence in the years to come.

The surveillance exercise will also provide the opportunity of close policy cooperation and exchange of information. It can be expected that, over time, this forum would evolve from purely ‘negative’ coordination preventing budgetary misbehaviour to a more ‘positive’ form of coordination aimed at achieving an optimal fiscal stance for EMU as a whole.

### Annex

**Timetable of the Steps in the Excessive Deficit Procedure**

<table>
<thead>
<tr>
<th>Year $N$</th>
<th>Year $N+1$ and thereafter</th>
</tr>
</thead>
<tbody>
<tr>
<td>March</td>
<td>Member states of the EU submit data&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>Commission prepares report</td>
</tr>
<tr>
<td>April</td>
<td>Economic and Financial Committee (the successor to the monetary committee) formulates opinion</td>
</tr>
<tr>
<td></td>
<td>European Commission prepares opinion</td>
</tr>
<tr>
<td>May</td>
<td>Ecofin decides on excessive deficit and issues recommendations</td>
</tr>
<tr>
<td>September</td>
<td>Ecofin assesses ‘effective actions’ and may decide to publish recommendations</td>
</tr>
<tr>
<td></td>
<td>Member states submit data&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>October</td>
<td>Ecofin gives notice of specific measures</td>
</tr>
<tr>
<td>December</td>
<td>Ecofin decides to apply sanctions</td>
</tr>
</tbody>
</table>

*Note:* <sup>a</sup> According to Council Regulation (EC)/3605/93, member states must submit budgetary data twice a year: first until 1 March at the latest, afterwards until 1 September at the latest.

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