Fiscal Sustainability in EMU

From the Stability and Growth Pact

To A Stability Council for EMU

Jürgen von Hagen

ZEI, University of Bonn, Indiana University, and CEPR

December 2003

Correspondence:

Walter Flex Strasse 3

D-53113 Bonn, Germany

Germany

Tel: +49-228-739199

Fax +49-228-731809

vonhagen@uni-bonn.de

www.zei.de

1. Introduction: Europe's Fiscal Framework under Stress

The European Monetary Union (EMU) is a new framework not only for monetary policy, but also for the fiscal policies of its member states. EMU is an exceptional monetary arrangement in that it confronts a monetary authority with multiple, large national fiscal authorities rather a single central government conducting fiscal policy at the level of the monetary union, as in conventional, national monetary systems. The need to create a genuine institutional framework to deal with this exceptional degree of fiscal decentralization in a monetary area was recognized clearly in the blue-print for EMU, the Delors Report (1989), which called for institutional safeguards of fiscal discipline in the monetary union, arguing that a lack of fiscal discipline might undermine the stability of the new currency.

Art 4(3) of the Treaty on European Union (TEU), i.e., the Maastricht Treaty and its successor, the Amsterdam Treaty, declares that "sound public finances" are one of the guiding principle of economic policy in the EU. EU Procedures with relevance to the conduct and coordination of fiscal policy are the Mutual Surveillance Procedure (Article 99), the "No-bail-out clause" (Art 103), the Excessive Deficit Procedure (EDP, Art. 104), and the Stability and Growth Pact (SGP, Council Regulations 1466/97, 1476/97, Council Resolution 97/C236/01-02). Art 99 holds that the member states of the EU regard their economic policies as a matter of common concern and coordinate them through the ECOFIN Council and on the basis of "Broad Economic Guidelines." The No-bail-out rule protects the Community and the member states from becoming responsible for financial liabilities of other member states against their will. The EDP sets up a detailed process of monitoring the public finances of the member states with a view to ensuring that they remain sustainable. The SGP refines and concretises the procedures of the EDP.

This framework has come under considerable stress in the last two years, the time when it was tested seriously in a situation of economic downturn. There is now an intense public debate over the issue, and proposals for changes of the current framework range from simply abolishing it to strengthening its rules. In this paper, we review the background of this debate and develop our own proposal for reform. We begin with a discussion of the institutional developments. In section 3, we turn to the issue of fiscal discipline and growth in EMU. Section IV presents our proposal, the creation of an independent Stability Council for EMU. The final section concludes.

2. Fiscal Discipline in EMU

A basic belief underlying the framework of EMU is that the stability of the common currency requires the stability of public finances. Although the post-World War II inflations in the industrialized countries were not caused by excessive public debts, the fear that high and rising public debts would undermine the central bank's ability to deliver price stability has left

its mark in all important documents and political decisions on the way to EMU. In terms of technical economic analysis, fiscal policy and monetary policy are indeed linked through the "intertemporal budget constraint," the requirement that, in the long run, the discounted sum of a government's expected expenditures cannot exceed the discounted sum of its expected revenues.[1] If the government can print money, seignorage is part of its expected revenues. Thus, given an expected stream of expenditures in the future, and given an expected stream of tax revenues, seignorage has to make due for any shortfall of the latter over the former. If closing the gap requires printing more money, inflation will be the consequence.

In EMU, the issue is somewhat more complicated, because the governments of the individual member states have given up the right to print money. Seignorage will be paid to them in the form of central bank profits, but, since the central banks are politically independent and, by virtue of the Treaty on European Union (Art. 104 TEU and Art. 21.1 of the ECB Statutes) cannot directly monetize public debts, seignorage should be exogenous to government policies. That is, given an expected stream of expenditures and an exogenous flow of seignorage, the governments must adjust taxes to assure that the intertemporal budget constraint holds. Otherwise, they will be forced at some point to default on their debts. A fiscal crisis would arise, but it does not create inflation in the monetary union, unless the central bank bails out the troubled government.[2] The critical question therefore is, whether or not the ECB's institutional independence and its will to use it to safeguard price stability are sufficiently strong for it to withstand any political pressures to provide a bailout.

A second consideration within a monetary union is that the inflation caused by a bailout is spread over the entire monetary area and, ceteris paribus, is lower for the government demanding a bailout than it would be, if that government still issued its own currency. Thus, EMU reduces the inflation cost of a bailout of a given size, and excessive public debts create negative externalities for the citizens of other countries, if the ECB provides a bailout. This means that the incentives to maintain sustainable public finances are weaker in EMU than in a national monetary system. Unless there is complete certainty that the ECB will never provide a bailout, one should, therefore, expect that fiscal policy is less disciplined in a monetary union.

Both considerations lead to the conclusion that EMU needs some rules preventing the national governments from running up excessive levels of debt that would, in the long run, threaten the common good of the monetary union, i.e., price stability. The difficulty with that conclusion is in the question of how to translate it into a framework that guides and

---

[1] See e.g. Sargent and Wallace (1981).

[2] Note that, while the ECB cannot legally bail out a government in fiscal difficulties by buying its debt directly, it can still do so indirectly, if it wants to. A bailout could be ex post, with the central bank buying up large amounts of government debt in the market, or ex ante, with the central bank holding down interest rates to reduce the government's interest payments.

constrains the governments' fiscal policies in the short run. As noted above, the governments' intertemporal budget constraint pertains to the long run, therefore, it has small if any implications for annual budgetary policies and fiscal flows.[3] In a world with perfect information and no transactions costs, the solution could be to adopt a fiscal policy rule stating in detail what governments should do under what circumstances to meet the intertemporal budget constraint. In reality, the world is too complex and uncertain to do that. A simple fiscal rule limiting annual government deficits or debts is of little use under such circumstances, because it would constrain the governments' fiscal policies either too much or too little in the short run. Either way, it would lack credibility. In the first case, because it may force sovereign governments under some circumstances to adopt policies that are unreasonable or even damaging for their own countries; in the second case, because it would have not bind government actions sufficiently in the short run.

Furthermore, simple rules are not adequate to assure sustainability because, in the European context of supranationality, a rule must treat all member states equally even, if they are unequal. For example, a rule for the annual budget deficit ratio must be based on an assumption about the long-run nominal growth trend of the member economies, if it is to stabilize the debt ratio, G. Given a rate of inflation in the euro area of, say, two percent annually, the allowable deficit ratio is $d = (a+0.02)*G$. With $G = 0.6$, the allowable ratio is 4.8 percent for a country like Finland growing at six percent on average, but only 1.8 percent for a country such as Germany, whose trend growth rate is about one percent.

Finally, it is important at this point to note the distinction between sustainable public finances and optimal public finances. Optimal public finances are the solution to an optimization problem which consists of a set of policy goals, political preferences regarding policy outcomes, resource constraints, and (assumptions about) the laws describing the functioning of the economy. Designing optimal policies is, therefore, by nature a political task. Sustainability is just one of the resource constraints that must be fulfilled in this task, i.e., all optimal policies are sustainable, but not all sustainable policies are optimal. This distinction is relevant for two reasons. First, governments in EMU may choose to coordinate their fiscal policies in order to achieve more efficient, jointly optimal outcomes. But policy coordination is an issue logically different from sustainability and it is a political process requiring agreement on policy choices. Countries in EMU may or may not decide to coordinate sustainable policies, but sustainability itself is not a reason nor a justification for coordination. Second, the more a framework meant to achieve sustainability constrains short-term fiscal policies, the more likely it is to get in the way of optimal policy choices in the short run. Too much emphasis on the short run, therefore, has the result of politicizing the framework for

[3] This is best seen in the fact that governments can always promise future actions to collect more revenues to compensate for today's deficits. See Perotti et al. (1998) for a more detailed

sustainability to an unnecessary extent. The proper response, therefore, is to design a framework that combines guidelines for short run budgetary policies with proper judgment about current and future developments.

2.1. The Excessive Deficit Procedure and the Stability and Growth Pact

The EDP is the cornerstone of the fiscal framework of EMU. It combines the unconditional obligation on the part of the member states to avoid "excessive deficits" with a procedure providing a regular assessment of fiscal policies in EMU and, if necessary, penalties for profligate behavior (Article 104 TEU). The TEU charges the European Commission with the task of monitoring budgetary developments and the stock of public sector debt of the member states, checking in particular their compliance with two *reference values* for the ratio of the deficit to GDP the ratio of public debt to GDP. The two reference values are set at three and 60 percent, respectively (Protocol on the EDP). If a member state does not comply with these reference values, and unless the deficit and the debt are approaching their reference values in a satisfactory way, or the excess of the deficit over the limit is exceptional and temporary, the Commission writes a report to the European Council, taking into account whether the deficit exceeds public investment spending and "all other relevant factors, including the medium term economic and budgetary position" (Art 104(3)) of the country concerned.[4] If the Commission considers that an excessive deficit exists, it makes a recommendation to the European Council, which votes on it by qualified majority after taking into account any observations the country concerned may make and the opinion of the Economic and Financial Committee (EFC), which advises the Council in these matters (Art. 114). The decision whether or not an excessive deficit indeed exists is made by ECOFIN.

If ECOFIN decides that an excessive deficit prevails, it makes confidential recommendations to the country concerned on how to correct the situation within a given period of time. If the country does not take appropriate action and does not respond to the ECOFIN's recommendations in a satisfactory way, ECOFIN may make its views and recommendations public, ask the government concerned to take specific corrective actions, and, ultimately, impose a financial fine on the country. In that case, the country would first be required to make a non-interest bearing deposit with the Community. If the excessive deficit still persists, this deposit would be turned into a fine paid to the Community.[5] The Council can abrogate its decisions under the EDP upon a recommendation from the Commission. All

---

discussion.

[4] According to Art. 104(3) the Commission may also prepare a report if a member state complies with the criteria but the Commission sees the risk of an excessive deficit nevertheless.

[5] Note that neither the deposit nor its conversion into a fine affect the budget of the country in question as both are financial transactions.

Council decisions in this context are made by qualified majority; once a country has been found to have an excessive deficit, its votes are not counted in these decisions.

In the context of the EDP, the numerical criteria for deficits and debts thus serve as triggers for an assessment prepared by the European Commission and made by the European Council. They do not themselves define what an excessive deficit is, nor does breaching them imply any sanctions *per se*. Since they merely serve as triggers for a more precise assessment of the situation, there is no need to make the criteria themselves responsive to economic circumstances, e.g., by redefining them to exclude interest spending or cyclical effects on spending and revenues. These and other circumstances can be accounted for in the Commission's analysis, EFC's opinion, and the Council's judgment. In view of the need to balance long-term objectives with short-run constraints on actual policy, such a trigger-role is appropriate for the numerical criteria.

During the mid-1990s, however, public fears arose in Germany that the EDP might not suffice to discipline fiscal policies in EMU effectively. Given the rules of the procedure, such fears could only reflect a lack of credibility of the ECOFIN, which passes the ultimate judgment and adjudicates the fines foreseen under the EDP. This lack of credibility is, in fact, easily understood. By assigning the right to decide whether or not an excessive deficit exists to ECOFIN, the EDP effectively makes a group of "sinners" judge the performance of fellow "sinners." Considering the fiscal performance of other governments, Council members have all reason to be lenient and avoid actions that are politically costly for fellow members, anticipating that they might be in a similar position in the future. This makes political deals more likely than serious judgment and the application of sanctions by ECOFIN.

Germany's finance minister at the time, Waigel, responded to these fears by proposing a "Stability Pact" for EMU, which was later adopted as the "Stability and Growth Pact" (SGP) by the European Council.[6] The SGP modifies the EDP in several ways. First, it sets up an early warning system strengthening the surveillance of the public finances of the member states. Under the SGP, EMU member states submit annual Stability Programs to the European Commission and the European Council explaining their intended fiscal policies and, in particular, what they plan to do to keep the budget close to the new and stricter medium term objective of "close to balance or in surplus." Implementation of these programs is subject to the scrutiny of the Council, which, based on information and assessments by the European Commission and the EFC can issue early warnings to countries that risk significant deviations from the fiscal targets set out in their Stability Programs. The goal of the Stability Programs is to achieve and maintain budgetary positions of close to balance or in surplus.

Second, the SGP clarifies the EDP by giving more specific content to the notions of exceptional and temporary breaches of the three-percent limit and by defining the rules for

[6] For an account of the genesis of the SGP see Stark (2001).

financial penalties, and it speeds up the process by setting specific deadlines for the individual steps. Third, the SGP gives political guidance to the parties involved in the EDP, calling them to implement the rules of the EDP effectively and timely. It commits the Commission in particular to using its right of initiative under the EDP "in a manner that facilitates the strict, timely, and effective functioning of the SGP." This puts severe limits on the Commission's right to exercise judgment on each individual case and situation, shifting that right to the Council instead.

The rules of the SGP have been further developed in a set of ECOFIN decisions regarding the format and content of the Stability Programs.[7] In October 1998, ECOFIN endorsed a Monetary Committee (the precursor of the Monetary and Financial Committee) opinion, the "code of conduct" specifying criteria to be observed in the assessment of a country's medium-term budgetary position and data standards and requirements for the Programs. In October 1999, ECOFIN recommended stricter compliance with and more timely updating of the Programs. In July 2001 ECOFIN endorsed an appended code of conduct proposed by the EFC refining the format and the use of data in the Stability Programs, including the use of a common set of assumptions about economic developments outside the EMU. Meanwhile, the Commission (2000) has specified a detailed framework of interpretation for the divergences from the targets set in the Stability Programs.

Compared to the original EDP, the SGP has achieved two things. First, it has changed the nature of the fiscal framework from one based on informed judgment to a simple numerical rule constraining annual deficits. Second, while the Maastricht Treaty gave the Commission considerable discretion in initiating the EDP and moving it forward, the SGP, has reduced the Commission's role and raised the importance of the Council's judgments and decisions. In doing so, the SGP has shifted the balance of power in the fiscal policy framework from the institutional guardian of the Treaty to the representatives of the member states, thus politicizing the process and the relevant decisions more than the original EDP.

Both changes have reduced the credibility of the fiscal framework. Anticipating that the Council will tend to avoid serious judgment and the application of penalties, the European public will naturally dismiss arguments brought forth by the Council explaining why individual violations of the criteria and provisions should be accepted under special circumstances, even if these arguments were justified. As a result, the SGP has reduced the weight of sound economic judgment and increased the attention and emphasis the public puts on the numerical criteria. Public opinion and financial markets have begun to take the numerical deficit rule more seriously than a sensible economic procedure would warrant.This has made the entire process more rigid than necessary. As a result, the fiscal framework is increasingly perceived as a straightjacket for fiscal policies, and especially so in the large EMU countries.

---

[7] See European Commission (2002), p. 23

There is now a serious risk that the SGP will, in the end, cause the opposite of what it intended: As the large EMU countries have decided – more or less openly - not to accept that perceived straightjacket any longer and ignore the rules, EMU could be left with less instead of more protection against fiscal profligacies.

2.2. Experiences in the 1990s

In 1992, the EU's average debt ratio was almost 60 percent of GDP – hence the 60 percent limit foreseen in the Maastricht Treaty.[8] It climbed to almost 75 percent in 1997, the base year for the May 1998 decision on which countries could enter EMU. Since 1997, the average debt ratio has fallen to 63 percent. In contrast to what EU officials and politicians like to tout, the data do not show that the Maastricht process for fiscal consolidation was successful.

Several qualifications apply. First, the increase in the average debt ratio was driven mainly by debt expansions in five states: Germany (from 44% to 61%), France (from 40 % to 56%), Spain (from 48% to 70%), Italy (from 109% to 124%), and the UK (from 42% to 55%). While Belgium and Luxembourg almost stabilized their debt ratios, the Netherlands and Ireland enjoyed falling debt rations during this period. The debt ratios of the other states were stabilized or fell after 1992.[9] Do the EDP and SGP work more effectively in small EMU states than in the large ones? To answer this question, Table 1 reports the changes in the debt-GDP ratios for large states (states, whose GDP in 1997 was at least seven percent of EU GDP), Germany, Spain, France, Italy, and the UK, intermediate states (states, whose GDP is between two and seven percent), Belgium, the Netherlands, Austria, and Sweden, and small states (whose GDP was less than two percent of EU GDP), Denmark, Greece, Ireland, Luxembourg, Portugal, and Finland. The combined GDP of the large states is 80 percent of EU GDP, that of the intermediate states 13 percent, and the small states have a combined GDP of 7.7 percent of EU GDP. The table shows that, between 1992 and 1997, the average debt ratio of the small states increased by just 3.3 percent, much less than that of the large states, which rose by almost 19 percent. Between 1997 and 2001, the small states achieved a reduction in their debt ratios by almost 20 percent, much more the 5.3 percent of the large states. Intermediate states behaved much like small states during this period.

Note: Data source is European Economy Statistical Appendix Spring 2002, published by the European Commission DG ECFIN.

This suggests that the fiscal framework is indeed more effective in the small than in the large states, which implies that it is most effective where it matters the least, since a

---

[8] The 3 percent deficit limit under the EDP derives from the 60 percent debt limit assuming an average nominal GDP growth rate of five percent in all EMU member states.

[9] Austria's and Finland's debt ratios increased after 1992, but these countries were not bound by the EDP at the time.

fiscal crisis in a small EMU member state would hardly threaten the stability of the common currency. In contrast, a fiscal crisis in a large state might do that, and there the fiscal rules seem much less effective.

The second qualification is that the observation of fiscal consolidations in some EU states during the 1990s cannot simply be attributed to the Maastricht process. Since most European countries had had sizeable fiscal expansions during the 1970s and 1980s, a period of consolidation could be expected in the 1990s anyhow. A study of European fiscal policy in the 1990s (Hughes Hallett, Strauch and von Hagen, 2001) considers this argument in detail. It shows that the observed consolidations in the 1990s could well be expected just by extrapolating patterns of fiscal behavior of EU states in the 1970s and 1980s. The evidence of a "Maastricht effect" speeding up or enforcing consolidations is weak at best.

3. Fiscal Performance Since the Start of EMU

3.1. Fiscal Policy Stance

All EU countries enjoyed declining debt ratios since between 1997 and 2001. But, with the exception of 2001, the same years were also period of relatively strong growth in Europe. Since the fiscal performance is measured in terms of debt and surplus ratios relative to GDP, it is not clear to what extent the observed reductions in government debt and deficit ratios can be attributed to government policy as opposed to windfall gains from strong economic growth. In this section, we assess the recent performance trying to separate policy from the effects of growth. We use a simple method of growth accounting. For each year, we estimate the change in the government surplus ratio due to economic growth and a "neutral" policy. Subtracting the two from the observed change in the surplus ratio gives us an estimate of the active policy stance. [10] Let the primary surplus ratio, s_t , be

$$s_t = \frac{R_t - G_t}{Y_t} = (r_t - g_t), \quad (1)$$

where R denotes government revenues, G non-interest government spending, and Y GDP. The change in this ratio over time then is

$$\Delta s_t = \frac{\Delta R_t - \Delta G_t}{Y_{t-1}} - \frac{\Delta Y_t}{Y_{t-1}}(r_t - g_t), \quad (2)$$

where r=R/Y, and g=G/Y. We define a "neutral" fiscal policy as one that keeps the average tax rate, r, and the ratio of government spending to trend GDP constant. With this definition, the contribution of the neutral policy to the change in the surplus ratio is

---

[10] Alternatively, one might base similar calculations on the OECD's cyclically adjusted budget balance and the OECD's estimates of changes in structural balances. These estimates, however, are

$$\Delta s_t^N = \frac{\Delta Y_t}{Y_{t-1}} r_{t-1} - \left(\frac{\Delta Y}{Y}\right)^{trend} g_{t-t}. \tag{3}$$

The contribution of economic growth to the change in the surplus ratio is defined as

$$\Delta s_t^G = g_t \left[\frac{\Delta Y_t}{Y_{t-1}} - \left(\frac{\Delta Y}{Y}\right)^{trend}\right]. \tag{4}$$

This is the change that would occur in addition to the neutral change, if the government simply allowed economic growth above or below trend to change the expenditure ratio. We estimate the trend growth rate as the average real growth rate during the 1990s. Using these definitions, we obtain the policy-induced change in the surplus ratio as

$$\Delta s_t^P = \Delta s_t - \Delta s_t^N - \Delta s_t^G. \tag{5}$$

We use this part as our indicator of fiscal policy stance, since it measures the active contribution of any policy actions to observed changes in the surplus ratio. Figure A has our calculations for the years from 1998 to 2002. Since the decision on EMU membership was taken in 1998 on the basis of fiscal data for 1997, 1998 was the first year after 1992 in which the governments of the EMU member states were no longer under the risk of not making it into the monetary union due to excessively lax fiscal policies. In the figure, a negative number indicates a fiscal expansion, a positive number a fiscal contraction.[11]

The figure bears a number of interesting observations. The first is that on average, the EMU average policy stance was expansionary in 1998 and, very much so in 2000, neutral in 1999, 2001, and 2002, despite the weaker economic performance of that year.

The second observation is that “consolidation fatigue” – the loss of political interest in pursuing further consolidations - emerged in many countries in the first year after the threat of not making it to EMU membership had disappeared. The (non-weighted) average fiscal impulse among the EMU member countries in 1998 was –1.12 percent of GDP, with a standard deviation of the mean of 0.24. This compares to an average fiscal impulse in all other country-years of –0.54 percent of GDP with a standard deviation of 0.17. The t-test for equal means yields a statistic of t=-3.2, which indicates that the 1998 fiscal impulses were significantly more expansionary among the EMU member states. Thus, these countries used the first opportunity to relax fiscal policies, and this although 1998 was a year of relatively strong economic growth. Interestingly, the countries that did not join EMU in 1999, Denmark, Greece, Sweden, and the UK all maintained tight or contractionary fiscal policies in 1998.

---

based on past data and policies in the 19870s and 1980s. If the 1990s brought a change in the fiscal policy regime in Europe, they could be quite misleading.

[11] See Hughes Hallett, Strauch, and von Hagen (2000), and Hallerberg, Strauch and von Hagen (2001, 2002) for similar calculations and results.

The third observation emerges from considering the election dates in European countries in recent years. If governments use fiscal policies to improve their chances for reelection, one should expect fiscal expansions in the year preceding the election. Table 2 indicates which years were pre-election years in which EU country. Here we count both parliamentary and presidential elections where applicable.

Table 2: Preelection Years in EMU

Pre-election Year	1998	1999	2000	2001
Country	Austria, Belgium, Finland, Luxembourg, Portugal	Spain, Finland, Greece	Italy, Portugal	Germany, France, Portugal,Netherlands Ireland

Collecting the data from these country-cases, we find that the (unweighted) average fiscal impulse in pre-election years is –0.96 percent of GDP, with a standard deviation of the mean of 0.28. The average fiscal impulse in all other country-year cases is –0.65 percent of GDP with a standard deviation of the mean of 0.15. The t-test for the difference between the two averages is t=-1.7, which is significant at conventional levels. Thus, the data indicate that the fiscal strictures of the EDP and the SGP do not prevent governments from using fiscal policies to pursue electoral interests. Our estimates confirm similar results in Hallerberg, Strauch and von Hagen (2001), who use a somewhat different methodology.

3.2. Patterns of Fiscal Adjustment in EMU

At the European Council in Lisbon in 2000, the EU called upon its members to improve the “quality” of public finances. Without defining precisely what the “quality” of public finances means, the Council recognized that the structure of public spending and taxation has important consequences for economic growth and decided that the EU member states should aim at a more growth-friendly structure of public finances. Endogenous growth theory broadly suggests that a shift from taxing factor incomes to taxing consumption and a shift from public consumption and transfer spending to public investment has positive growth effects (Aghion and Howitt, 1998). Empirical results in this area are mixed, but they suggest that fiscal policies do have effects on growth.[12]

Subsequently, we characterize the fiscal policies of EMU member states to assess the strength of this conjecture. We do this with a series of cross section regressions focusing on the period since 1997. While the cross sections have obvious data limitations, the following bits of evidence add up to a picture that underscores the importance of the

[12] See e.g.

structure of fiscal adjustments and taxes and spending more generally.[13] We start by noting that the fiscal rules of the EDP and SGP focus on a reference value for public debt relative to GDP. There are two ways to reduce this ratio, slowing down the growth of nominal debt or speeding up the growth of GDP. Since inflation is no longer under the control of domestic monetary policy, the latter is equivalent to speeding up real GDP growth. A first question we look at considers the choice of the EMU government between these two options.

Let d = B/Y be the ratio of public debt, B, to GDP, Y. The relative contribution of growth in public debt and growth in real GDP to the change in this ratio in country i can be written as

$$C_t = 100\left(\frac{1+b_i}{1+g_i} - 1\right), \qquad (6)$$

where b is the growth rate of nominal debt and g is the growth rate of real GDP. If $C_i > 0$, the growth of public debt contributed more to the change in the debt ratio than the growth of real GDP, otherwise, real GDP growth dominated.

Figure 1 shows a plot of C_i against the real growth rates of the EU countries for two time periods, 1992-97 and 1997 – 2001. Positive values on the x-axis indicate that the change in the debt ratio during the period considered was due to growth rates of public debt in excess of the growth rate of real GDP. This was true in almost all EU countries in the first period. In contrast, public debt grew less than real GDP in all countries since 1997. Significantly, the figure also shows a strong correlation between the average real GDP growth rate over the post-1997 period and the relative contribution of GDP growth to the change in the debt ratio. Such a relationship did not exist in the first half of the 1990s.

Figure 2 gives a plot of the relative contributions of debt and real GDP growth against the change in the debt ratio during the period under consideration. In the earlier period, when debt ratios increase, this was due to debt growing much faster than real GDP. In the later years, however, the pattern is reversed. Countries that achieved a large decline in the debt ratio are countries that achieved high real GDP growth rates relative to the growth rate of debt over this period. Countries that achieved little real growth relative to debt growth also did not manage to reduce their debt ratios significantly. The figure thus suggests that a successful strategy to reduce the debt ratio is one that focuses on growing out of the debt burden rather than one that focuses on slowing down the growth rate of debt while neglecting economic growth. Taking figures 1 and 2 together, a clear message emerges. Without reviving economic growth, a significant reduction in the debt burden is unlikely. Taking the two periods together, another message is that rising debt burdens come from a lack of

[13] To facilitate reading the following figures, note that an R-square of 0.20 in the following regressions corresponds to the 10 percent critical value, and an R-square of 0.26 to the five percent critical value of the F-distribution of a test for statistical significance.

control over public sector debt. But to reduce an excessive debt burden, controlling debt is only a necessary condition. Without reviving economic growth, a significant decline in the debt burden seems unlikely. This suggests that the fiscal framework of EMU is ill conceived. The focus on deficits and debt growth alone would be justified if EMU had started in a period in which public debt burdens could be regarded as compatible with long run equilibrium. Given that a reduction in the debt burden is necessary particularly in the large countries, the policy framework pays too little attention to the role of economic growth in achieving sustainable public finances.

Next, we turn to public sector revenues and spending. In figure 3, we look at the relative contributions of debt and real GDP growth to changes in the debt ratio together with the changes in a number of fiscal indicators. In this figure, “revenue” and “total spending” refers to the ratios of public sector revenues and expenditures to GDP; “social transfers” and “investment” relates to the shares of transfers to households and total capital expenditures in total spending. The figure plots the changes in these indicators over the 1997-2001 period for the EU countries. The figure shows, first, that countries where expenditure and revenue ratios fell during this period are countries that achieved a larger contribution of economic growth to the change in the debt ratio, hence a larger reduction in the debt ratio. The R-squares of 0.36 and 0.45 indicate that these relations are statistically significant. Importantly, this suggests that a strategy of raising tax rates to increase revenues is unlikely to succeed in reducing an excessive debt burden, because it slows down economic growth. This is the German predicament of fiscal policy after 1994. Repeated increases in tax rates only resulted in ever less growth, with the result that Germany did not manage to get close to budget balance nor to reduce its debt burden sufficiently.[14]

The same figure also points to a critical role of investment spending and spending on social transfers. Countries that increased the share of investment spending tended to achieve a stronger contribution of GDP growth to the reduction in the debt burden, while the opposite is true for countries that increased the share of social transfers in total spending. We look at this issue in more detail below.

In Figure 4, we look at the tax burden and the composition of revenues. The figure plots the change in the tax burden and the change in the share of direct taxes in total revenues against the growth rate of real GDP. Direct taxes include social security charges on labor. We take direct taxes as rough proxies for the average tax rate on factor incomes. The figure shows that an increasing share of taxes on factor incomes goes along with a falling growth rate in this sample. Furthermore, a higher total tax burden in the economy goes along with a lower growth rate.

---

[14] For a detailed account of German fiscal policy in the 1990s see Strauch and von Hagen (1999).

In Figure 5, we look at the composition of total government spending in connection with the average real GDP growth rate of the EU countries in 1997-2001. The figure shows a strong association of higher shares of public investment and real GDP growth. Clearly, this correlation must be regarded with some caution, as public investment is not a very clear concept in practice.[15] Furthermore, the direction of causality might be that countries enjoying exogenously low growth rates cut public investment first, as political opposition against cutting transfer spending is more powerful than political opposition against cutting spending on public infrastructure etc. In fact, such political economy effects may be particularly large under the conditions of the EDP and the SGP, when governments are forced to cut public spending quickly to avoid violating the numerical constraints. Still, one would have to assume that public investment has no positive effect on growth at all to argue that this would not eventually lead to lower growth rates. The same figure also suggests that higher shares of transfer spending in total spending go together with lower rates of growth, although this relation is only marginally statistically significant.

Finally, in Figure 6, we look at the correlation between fiscal consolidation and real GDP growth. We do this by plotting the growth rate of public debt together with the growth rate of real GDP for the two time periods, 1992-97 and 1997-2001. The figure and the two regressions indicate that there is no significant correlation between these two. High growth rates of public debt in the early period apparently did nothing to stimulate economic growth, and lower growth rates in the latter period did not reduce growth. Nor does the figure give much credence to the concept of "non-Keynesian" effects of fiscal consolidations, i.e., the notion that a reduction in public debt would have positive growth effects by stimulating private investment and consumption (Giavazzi and Pagano, 1990). Such effects would lead us to expect higher growth rates for those countries where public debt actually shrank in the period under consideration. Obviously, the present bivariate framework is not sufficient to achieve a strong conclusion on this matter. Nevertheless, it is in line with the results from a larger econometric model presented in Hughes Hallett, Strauch and von Hagen (2001), which do not indicate "non-Keynesian" effects of the fiscal consolidations in Europe in the past decade. In passing, we note that our evidence here points to a methodological problem of earlier studies of such effects. Specifically, most studies identify fiscal consolidations as periods of significant reductions in public debt or deficit ratios, and "non-Keynesian" effects as episodes where consolidations go along with vigorous economic growth. The European experience suggests that such episodes may have more to do with policies that succeeded in stimulating growth by restructuring public spending and taxation and reducing tax burdens than with a reduction in public debt or deficits.

---

[15] For example, teacher salaries, which should be regarded as part of public investment in human capital, are counted as public consumption, and there is no consideration of the productivity of the

We can summarize the evidence from this section by pointing out the emergence of two alternative strategies of fiscal adjustment in EMU, represented most clearly by two groups of countries; see Table 4. On the one hand, there is a low-growth group of countries consisting of Germany, France, Italy and Austria. On the other hand, there is a high-growth group consisting of Ireland, Finland, Spain, and Greece. Low-growth countries have relied relatively much on stabilizing the growth of public sector debt to achieve the targets under the SGP, while high-growth countries have relied mainly on achieving strong economic growth. Clearly, the second group has been much more successful in moving towards sustainable public finances than the first group. The first group is also characterized by relatively small achievements in reducing tax burdens and by low and stable ratios of public investment. In contrast, the high-growth group, with the exception of Greece, has reduced their tax burdens and shifted government spending from welfare to public investment. Among the remaining countries, the Netherlands achieved an average growth rate of 5.3 percent and reduced its debt burden by almost 21 percent, relying much more strongly on growth than the low-growth group. Belgium, with a real growth rate of 3.9 percent and a reduction in the debt ratio of 23.4 percent follows a similar pattern. Portugal is more exceptional, as it achieved a relatively high growth rate of 5.3 percent, but reduced its debt ratio by no more than 8 percent.

Finally, it is interesting to observe that the non-EMU countries, Denmark, Sweden, and the UK look much more like the high-growth group in EMU during this period of time. The two Scandinavian countries in this group, however, reduced the share of public investment in total spending.

The experience of the early years thus indicates that the main condition for achieving a sustainable reduction of the debt ratio is to achieve a sufficiently large rate of trend real growth. Fiscal policy can support that by lowering the tax burden on factor incomes and by shifting expenditures from transfers to public investment. Do these results matter for EMU? After all, one might argue that the stability of the common currency depends only on the stability of public sector debt ratios. How this stability is achieved, might be left to the choice of the individual member states. The subsidiarity principle of the Treaty on European Union would then suggest that the EU should not interfere with these choices.

There are, however, at least two counterarguments to this. The first is that, if Europeans truly believe that public debt ratios must be low and sustainable, success in achieving this goal matters and is a valid concern for the Union. From this perspective, the current fiscal framework is incomplete, because it does not give EMU member states enough guidance for the choice of a successful fiscal strategy. Countries should be encouraged to adopt more growth-friendly policies by restructuring their tax and expenditure systems.

---

investment projects on which public funds are spent.

Table 4: Patterns of Fiscal Adjustment

	Real Growth	Change in B/Y	Relative Contribution of Debt and GDP Growth	Change in Share of Transfers	Change in Share of Investment
Low Growth	2.8	-6.8	-7.6	0.6	0.8
D	2.3	-2.5	-4.0	0.0	0.7
F	2.3	-3.9	-6.4	0.2	0.5
I	3.1	-16.2	-12.9	1.0	0.4
A	3.3	-4.7	-7.0	0.6	1.4
High Growth	7.8	-21.8	-28.2	-1.5	4.0
Ire	12.6	-38.5	-51.3	-2.8	6.0
SF	6.2	-15.2	-25.5	-1.4	0.4
EL	6.7	-20.0	-16.7	-1.1	8.4
E	5.6	-13.6	-19.3	-0.7	1.2
Non-EMU	4.0	-18.3	28.3	-0.3	-0.3
DK	3.4	-19.9	-30.3	-0.9	-0.5
S	4.3	-19.9	-26.3	0.6	-0.6
UK	4.4	-15.1	-27.8	-0.6	0.8

Second, it is necessary to recognize that EMU did not start under conditions of a long-run equilibrium as far as public finances are concerned. The low growth rates in Germany, France, and Italy in particular are the result of overregulated economies plagued by high tax burdens and welfare systems that discourage employment. The narrow focus of the EDP and the SGP on annual deficits, however, may keep governments from adopting reform policies that might result in larger deficits initially before the desired growth and employment effects kick in. If so, the current design of the fiscal strictures risks keeping these countries in a state of low-growth with insufficient progress also as regards the reduction of debts and deficits. One may reasonably doubt that these large EMU states will continue to tolerate such a scenario, which is perceived as keeping them from adopting better economic policies for the sake of some fiscal targets imposed by the EU. The recent episodes involving France and Germany clearly indicate that they will not. But if the outcome were that these countries simply continue to ignore the goals of the EDP and the SGP, other states would follow and the fiscal framework of EMU would fall apart.

3.3 SGP Crisis

In early 2002, an election year in Germany, the Commission noted that Germany missed its own Stability Pact targets by a significant margin and was approaching a deficit of 3 percent of GDP. The Commission proposed to issue an early warning, but, to avoid that, the German government achieved a deal with the other governments in ECOFIN under which Germany promised to balance the budget by 2004. That commitment was based on growth assumptions for the German economy that were widely regarded as unachievable under plausible economic circumstances at the time. After the German elections in September, the reelected government revealed that Germany was going to exceed the three-percent deficit ratio by a large margin. Finance Minister Eichel first postponed the goal of a balanced budget to 2006. During the following months, however, it became clear that Germany would again have a deficit ratio above three percent in 2003 and probably 2004. The federal government was unable to pass emergency tax legislation through parliament. After the Spring tax estimates for 2003, which indicated finally a huge loss of revenue for the German public sector in the upcoming years, minister Eichel finally announced that he no longer intended to balance the budget by 2006. In December 2002, ECOFIN decided that Germany had an excessive deficit. Nevertheless, the Commission decided in May 2003, that the German government had made sufficient efforts to reach budget balance and that, therefore, there was no need to consider a recommendation for financial fines.

Also in the spring of 2002, the newly appointed French government announced its intention to postpone balancing the budget until 2007 given current economic projections, three years later than its commitments from the previous Stability Program. France had a deficit ratio in excess of three percent in 2002; yet the French finance minister did not respond to the Commission's request for an adjustment program. In the Summer of 2002, the Italian government also stated that it intended to postpone the budget balance required under the SGP. Portugal received an early warning under the Excessive Deficit Procedure in the Spring of 2002 and has been declared by the ECOFIN Council having an excessive deficit.

When Germany's fiscal distress was revealed after the September elections, a heated debate about the future fiscal framework of EMU immediately sprang up. It was fuelled by a speech Commission President Prodi gave to the European Parliament in October, in which he called a strict adherence to that framework "stupid," yet without offering a clear view of what an "intelligent" reading of the framework might be. In September 2002, the Commission, in a surprise move, proposed to excuse EMU countries for not balancing their budgets before 2006 in view of weak cyclical conditions. Smaller EMU states saw this as a favor paid to the

large countries.[16] Importantly, the Commission proposed a set of targets and guidelines for fiscal policy and a more powerful machinery for fiscal policy coordination under its auspices in exchange for an extension of the time limit to reach budget balance. However, the ECOFIN Council of October 7, 2002, decided to reject the proposal, leaving it effectively up to the member states to decide when they wish to reach the target. ECOFIN also asked the Commission to present a study of the scope of further fiscal policy coordination. The Commission's study was presented in the Spring of 2003 and again proposed a stronger involvement of the Commission in short-term fiscal policies of the member states. The proposal was rejected by ECOFIN.

Soon after the German federal elections in September, the German government revealed its inability to stay below the 3 percent deficit limit in 2002. The Commission adopted the view that Germany had an excessive deficit on 19 November, and ECOFIN followed its proposal in January 2003. Soon after the spring tax estimates in May 2003, Germany's finance minister Hans Eichel indicated that Germany would breach the 3 percent deficit limit again in 2003, and that Germany would not be able to reach a balanced budget by 2006. Nevertheless, Commissioner Pedro Solbes, in a speech on 21 May, indicated his satisfaction with the German government's measures to correct the deficit, although the fiscal impact of these measures in still highly uncertain. Soon afterwards, on 13 June, the minister of economics, Wolfgang Clement, rather than the finance minister, set the year 2008 as a new target date for achieving budget balance in Germany. With the proposal to pull forward a tax reform originally planned for 2005, the German federal government showed that it did not regard the fiscal limits set by the Maastricht Treaty as a binding constraint.

At its January 2003 meeting, ECOFIN also issued an early warning against France. ECOFIN decided that an Excessive Deficit exists in France on 3 June 2003. In its recommendation, however, ECOFIN gave the French government until 2004 to adopt measures correcting the cyclically adjusted deficit by at least 0.5 percent of GDP. Noting that this was not consistent with the Euro group's commitment of the previous October, the Dutch government declared that it did not support that recommendation. In mid-July, the French government announced that it was going to breach the deficit limit of the SGP for the third time in 2004. Immediately afterwards, the French president Jacques Chirac called for a temporary softening of the Stability Pact, asking for a better compromise between stability and economic growth and solution that would take the individual circumstances of each country into account. EU Commissioner Pedro Solbes rejected that idea affirming that there was no need to reform the Stability and Growth Pact.

Negotiations between the Commission and France on the one hand and the Commission and Germany on the other hand became more intense in the early of 2003. The

---

[16] See Thomas Fuller (2002)

Commission insisted that France and Germany should make significant budgetary adjustments in 2004. In return, both countries would be allowed to return to a deficit below 3 percent in 2005. Both governments resisted that demand. In October, it was revealed that Germany's deficit in 2003 would exceed 4 percent by a large margin. Germany's Finance Minister refused the further spending cuts demanded by the Commission. At its critical meeting on 27 November, finally, the ECOFIN Council decided to end the Excessive Deficit Procedure against Germany. Effectively, it has decided to abolish the fiscal framework of EMU.

In the meantime, there has been no scarcity of proposals for reforms of the EMU fiscal framework in this debate. The proposals made so far can be categorized in three groups: Some authors insist that the current numerical rules must be preserved and that the procedures should be strengthened to avoid future crises. Others argue that the numerical rules should be kept but with increased flexibility. The Commission (2002) and Buti et al. (2003) propose to focus on structural balances rather than the actual deficit, a suggestion that was already incorporated in the 2001 Code of Conduct. Giavazzi and Blanchard (2002) call for a "golden rule" excluding investment spending from the budget. Coeuré and Pisani-Ferry (2003) recommend that the emphasis should be shifted to the debt ratio, and that countries with debt ratios below 40 percent should be excused from exceeding the three-percent line for the deficit ratio.[17] Finally, there is the Commission's proposal to increase coordination in return for greater flexibility.

None of these proposals will create a better framework for sustainability. Our analysis above suggests that the current crisis of the SGP has three sources. First, there is too much focus on numerical criteria for short-term fiscal flows, although the goal relates to the long run only. Increasing flexibility in some of the ways suggested by the current proposals may provide some relief in the current situation, but it will not solve the basic problem of how to translate the long-run budget constraint into meaningful guidelines for current policies. That is, situations in which governments claim that the constraints are too rigid will reappear even if some flexibility is introduced now. But repeated revisions of the framework tailored to the policy problems of the day will damage its credibility.

Second, the EMU has been unable to use the flexibility already provided by the current framework, which is due to the fact that the public does not regard the governments as credible judges of their own policies. Softening the deficit criteria would not solve that problem, on the contrary, it would be perceived by the public as an attempt to create more room for fudging budget data. Giving the Commission a greater role in monitoring budgetary developments would not solve the problem either, because, as a multi-task organization that relies heavily on the cooperation of the member states in achieving its goals, the

[17] Note that this would not provide any relief for France, Germany and Italy.

Commission is too politically dependent on the member states to have the required credibility.

Finally, the large member states have not been willing to accept the constraints of the EMU framework. It is unclear why softening the rules would increase that willingness.

4. A Stability Council for EMU

The fiscal framework of EMU needs improvements taking these problems into account. To achieve that a revision of the SGP should aim at two things: less focus on short-run fiscal flows and stronger surveillance and monitoring procedures. At the heart of the our proposal below is the idea to replace the rigid rules by a judgmental assessment of the fiscal situation and outlook of each euro-area member state and to entrust the judgment of sustainability to an independent institution, the European Stability Council. This would solve the basic credibility problem of the current framework. The proper link between the EMU's long-run interest in sustainability and short-run constraints and exigencies on fiscal policy would be preserved by the independence of the Stability Council short-term political pressures. [18]

The Stability Council would be legally set up by the European Parliament, which would also provide its resources. Its members should be individuals of high public regard as experts on public finance or public finance management. Membership in the Stability Council need not be a full-time activity for all members, although the chairman and the vice chairman should have full-time professional appointments. The Stability Council should have a small staff and secretariat and should have guaranteed access to all relevant information at the national and Community levels. The Stability Council should have the right to use the services of the European Commission and of the national government accounting courts to support its work.

The idea of creating yet another institution at the European level may seem unattractive to some. After all, the current European structure with its network of overlapping policy processes and its opaque institutional set up seems to call for less rather than more policy making bodies. Yet, the Stability Council would improve the transparency and visibility of the current institutional framework for public finances in EMU. Anticipating another criticism, some may find the idea of delegating some authority over public finances – historically the core of parliamentary rights – to an independent body as incompatible with modern democracy. Yet, as we will argue below, a properly designed Stability Council can improve the functioning of democratic government rather than limit it (von Hagen and Harden, 1994). The delimitation of the Stability Council's authorities and competences is the

[18] Our proposal builds on work originally presented in von Hagen and Harden (1994), further elaborated in Eichengreen, Hausmann, and von Hagen (1998). A related proposal drawing on these ideas was recently presented by Wyplosz (2002).

key issue here. In fact, several countries in the EU have already moved in this direction in recent years.

IV.1. Mandate

The Stability Council would have the sole statutory task of safeguarding the sustainability of public finances in the euro area. While this is the counterpart of the ECB's principal task of maintaining price stability, the Stability Council has no need of a secondary objective - supporting the general economic policies in the euro area – since it would have no *operative* role in fiscal policy. The use of the instruments of fiscal policy would be left entirely the national governments. Within the EMU framework, the function of the Stability Council is to make the implications of the governments' intertemporal budget constraint explicit. To fulfill its task, the Stability Council must assess the financial position of a government in all relevant aspects, produce forecasts of future financial developments and, on this basis, evaluate the risk of future fiscal crises.

Like 'price stability', the empirical content of the concept of sustainability of public finances is rather vague, and it varies with economic circumstances over time and across countries. An important part of the Stability Council's task is, therefore, to develop a framework for the assessment of public finances and for making forecasts and judgments. This, again, is similar to the task of the ECB. Yet, it is unlikely that the Stability Council will settle on a unique number in this definition as the ECB did for price stability. In fact, there is no need to do that, since, in contrast to the ECB's case, the Stability Council is not charged with the implementation of sustainability and, therefore, its definition of sustainability is not needed to hold it accountable for its actions in the short run. Thus, the Stability Council is free to develop an empirical concept of sustainability that overcomes the basic problem, i.e., that general numerical limits are not meaningful in this context.

The fact that the Stability Council would not have the authority to set taxes nor expenditures for a country is key for its democratic legitimacy. The Stability Council's mandate would be to make the limits that monetary union imposes on national fiscal policy choices explicit. This is a legitimate interest of the union, and it can be assumed that national parliaments and governments, by agreeing to enter a monetary union dedicated to price stability, agreed to accept those limits. Thus, the creation of a Stability Council does not take away further sovereignty from national governments compared to what is implied already by entering EMU.

Nevertheless, the Stability Council could hardly judge the sustainability of a country's public finances without taking into account a view of the proper size and structure of the public sector in that country. While the assessment of a country's fiscal situation and outlook may contain recommendations regarding the total volume and distribution of public spending

and revenues, fixing these volumes would be beyond the mandate of the Stability Council. Thus, the Stability Council may find itself in disagreement with national government, precisely because the latter desire an increase in the public sector. Governments could improve the process and ensure that the Stability Council's decisions were linked to democratic political choice by announcing, on their part, multi-annual targets for the size and structure of the public sector. Such targets, if announced by a government upon coming into office, would most likely become part of each political party's electoral platform, and, thereby improve the democratic accountability of the governments in public finances.

IV.2. Method of Operation

The national governments would submit their annual and medium-term fiscal plans to the Stability Council, which would judge the compatibility of the implied change in general government debt with sustainability. The Stability Council would make its judgment and the underlying reasoning public in a written report to the European Parliament and propose adjustments from the national governments.

Note the substantial difference between the change in general government debt, the main focus of the Stability Council and the reference values of the Maastricht Treaty. The Treaty defines a deficit on an accruals basis, implying that some items are excluded that the Stability Council would cover in its limit, such as privatization receipts, capital ("below-the-line") transactions, or changes in the value of foreign-currency denominated debt. The Stability Council would, therefore, take a more encompassing view and judgment. Furthermore, the change in general government debt considered by the Stability Council would set an unambiguous limit on government borrowing. In contrast to the Excessive Deficit Procedure, there would be no more room nor a need for judgment once this has been established.

The Stability Council could have procedures that allow for involvement with different degrees of intensity for different countries. For example, the Stability Council could apply a simple first test using some rather broad brushed analysis and turn to a more intensive investigation only in cases where the first test is failed. The three percent and sixty percent criteria of the Excessive Deficit Procedure are examples for such a first test. This would likely reduce the number of countries investigated intensively each year and, therefore, allow for a smaller administration.

To fulfill its task, the Stability Council would produce an annual report on the sustainability of public finances in each member state and submit it to the European Parliament. In the preparation of the report, the Stability Council would, without prejudice to its independence, allow for participation of the national governments and other institutions such as the ECB in the process, e.g., by holding hearings with experts and representatives of

the relevant bodies. The Stability Council should use all relevant information for its tasks and be able to obtain that information.

IV.3. Enforcement

Under the European Treaty, member states of EMU have the unconditional obligation to safeguard the sustainability of public finances. If the Stability Council has the mandate of defining and operationalizing what sustainability means and implies for national fiscal policies in the short run, this obligation implies that national governments are committed to implementing the Stability Council's judgments and prescriptions.

The question remains, how this commitment can be enforced. The current framework of public finances in EMU relies on two enforcement mechanisms, peer pressure and the possibility to impose financial fines on countries with persistent excessive deficits. But the effectiveness of these enforcement mechanisms remains very much in doubt. While peer pressure has not worked regarding the large states, Germany, France, and Italy in particular, the effectiveness of the threat of financial fines remains to be tested in the EMU framework. But the lenience with which Germany's fiscal developments were treated in 2002 and 2003 suggests that the European Commission and the Council wish to avoid that test. ...

It is clear that the Stability Council can rely neither on peer pressure nor on financial fines. As a Community institution, it does not talk to the national governments in the same way as ECOFIN does. At the same time, the Council could not impose penalties on national governments, because its role is different from the role of the Community's European Court of Justice. Therefore, the Stability Council would have to rely primarily on political pressures generated through public opinion to enforce its judgments. To do so, the Council must have the right to make its judgments and recommendations fully public in a timely manner. This includes the right to make press declarations on individual cases, and to educate the public opinion though public statements about the importance and the proper interpretation and implementation of sustainability. It also includes the right to talk to the European Parliament and to national parliaments. The Stability Council must have the right to make differentiated judgments on the fiscal situation of each member state in public, pointing to risks and problems as it sees fit. Finally, in order to create clear competences and avoid political haggling, the Stability Council should have the sole right to recommend to the ECOFIN Council the imposition of financial fines under the Excessive Deficit Procedure of the European Treaty, and the ECOFIN Council should be required to take a vote on that proposal.

Enforcement in this way can only work, if the public regards the Stability Council as an authority on this matter in the public. A Council making unreasonable judgments or posing unreasonable demands on national governments frequently would soon lose attention in the

public debate, as would a Council basing its judgments on shaky analysis and questionable assumptions. The need to rely on public opinion, therefore, creates a strong incentive for the Stability Council to exert good judgment, to use its public role carefully and to refrain from making public announcements and hinting at impending fiscal crises unless the situation is truly severe..

Finally, governments in EMU should have an opportunity to prepare a response in reasonable time and not be taken completely by surprise by announcements of the Stability Council. This can be achieved by demanding that the Stability Council forwards its assessment of a country to the relevant government a few days before it is made public.

IV.4. Independence, Accountability, and Transparency

To fulfill its role properly and make unbiased judgments, the Stability Council must enjoy full political independence of the national governments of the member states and of other Community institutions such as the European Committee. Like the independence of the European Central Bank, the independence of the Stability Council is determined in four statutory rules. First, a rule stating that the Stability Council does not take any directives from any national government of EU member states, from other national institutions of EU member states, nor from any Community institution. Second, a rule stating that the Stability Council has the right to develop its own framework of analysis and its own operational concept of sustainability.

Third, a rule determining the resources available to the Stability Council. This rule should fix the Stability Council's budget for a medium-term horizon, say, five years, and should be amendable only by a qualified majority of the votes in the European Parliament. Such a rule would shield the Stability Council from short-sighted attempts of politicians to make it ineffective by draining it from resources.

Fourth, the members of the Stability Council should be personally independent from political pressures. Following the example of the European Central Bank, personal independence can be assured by giving the council members fixed term, non-renewable appointments of sufficient length, say, eight years, to acquire the necessary expertise and standing in the public debate. Appointments should be staggered to assure that the Stability Council does not change entirely and the end of a given year, thus assuring continuity in its views and judgments. It should be impossible to dismiss members of the Stability Council except for severe faults of unethical or unprofessional behavior to assure that they cannot be threatened to be removed from their positions if they take decisions which are unpopular with the governments. Salaries of Stability Council members should be determined by a formula, laid down by the Council's statutes and linked to the salaries of comparable EU offices.

The independence from political pressure should be balanced by appropriate mechanisms of accountability. As indicated above, the Stability Council should report to the European Parliament. The European Parliament should have the right to call the chairman of the Stability Council for hearings and the right to dismiss the Stability Council *in toto* by qualified majority of the European Parliament. Given the large publicity that such an action would have, the European Parliament would do that only in cases of severe misperformance of the Stability Council.

The independence of the Stability Council should also be balanced by a high degree of transparency of its operation. Limited transparency would only reduce the effectiveness of the Stability Council's public announcements, as they might raise doubts about the competence and unbiasedness its deliberations and judgments. This calls for the publication of all materials relevant for a decision by the Stability Council as well as the minutes of its meetings. However, there is no need to do this immediately after the meeting or decision, a requirement that might affect the Stability Council's ability to obtain and process all relevant information. The Stability Council could choose a publication lag of, say six to twelve months, within which all relevant information is published.

Apart from that, all members of the Stability Council should be free to express their views on the sustainability of the public finances of individual countries. This would promote open and public debate about the relevant issues in member states where sustainability is indeed at risk, and, therefore, raise public pressures on the governments to correct the situation.

IV.5. Appointments, Composition and Resources

In the context of fiscal policy, the role of the Stability Council would be a fairly technical albeit important one. Its members should have sufficient experience and public. In some member states of the EU, academics with the necessary expertise would probably be regarded as appropriate candidates, while in other member states, such candidates would count as irrelevant and the public prefer individuals with careers in international institutions such as the IMF. Since the appointment of the members would be by the European Parliament, the members of parliament could take care of such national differences in preferences through the nomination procedure. For a European institution, the question of country representation naturally arises. Since the role of the Stability Council is not to make policy choices, representation of all countries at all times would not be important for its legitimacy.

By decision of the European Parliament, the Stability Council should be vested with the resources necessary to fulfill its task. This includes a staff for producing the necessary

analysis and a small secretariat. EMU member states must be required to give the Stability Council full and timely access to all information requested.

V. Conclusions

The creation of the Stability Council would improve the political process of public finances in EMU. It would allow for greater flexibility in the use of fiscal policy instruments, as the Stability Council would not focus narrowly on numerical criteria and be able to use and apply good economic judgment, instead. This increase in flexibility would not come at the cost of less credibility in the eyes of the public, since the Stability Council would have no need to take short-term political concerns into consideration when they judge public finances. The review process of the Stability Council would change the public awareness of the problem by being more transparent and more focused on the critical issues connected to sustainability. Like price stability, sustainability is a difficult concept that needs continuous education of the public to build democratic support. The Stability Council would be in a good position to deliver that, because sustainability would be its sole mandate.

How does our proposal relate to the current framework for public finances in EMU? One obvious question relates to the status of the Stability Council within the Excessive Deficit Procedure and the Stability and Growth Pact. The existence of the Stability Council together with the current framework could pose some difficulties. The fact that the Maastricht criteria and the assessment of the Stability Council do not coincide implies the possibility of a conflict between a strict compliance with the rulings of the Stability Council and the Excessive Deficit Procedure of the Treaty. Situations could arise in which the Stability Council declares that the sustainability of a member country's public finances is at risk, while the actors under the Excessive Deficit Procedure and the Stability and Growth Pact come to the opposite conclusion. The political haggling involved in such situations would undermine the authority of all institutions and procedures, leaving EMU with less protection against fiscal profligacy. To avoid that risk, the provisions of the Excessive Deficit Procedure and the Stability and Growth Pact should be amended to clarify the authority of the Stability Council in these matters.

It is noteworthy that a number of EU countries today already have institutions at the national level which resemble in some ways the Stability Council. In Belgium, the High Council of Finances coordinates the fiscal policies between the national government, the regional governments and the communities. In doing so, it assesses the sustainability of the country's and the sub-entities' public finances and regulates their policies on an annual basis. In Austria, the reformed "Staatsschuldenrat" reports to the national parliament on issues related to the evolution of government deficits and debt. The Swedish parliament has

recently decided to set up a similar council at the national level, when Sweden enters EMU. Thus, the principle has gained some recognition already in Europe.

References

Balassone, Fabrizio, Daniele Franco, and Stefania Zotteri (2002), Fiscal Rules for Sub-national Governments: What Lessons for EMU Countries? Mimeo, Banca d'Italia Research Department, Rome

Aghion, Philippe, and Peter Howitt (1998), *Growth Theory*. Boston: MIT Press

Beetsma, Roel (2001), "Does EMU Need a Stability Pact?" in: Anne Brunila, Marco Buti and Daniele Franco (eds.), *The Stability and Growth Pact*. Houndsmill: Palgrave

Buti, Marco, Daniele Franco and Hedwig Ongena (1998), "Fiscal Discipline and Flexibility in EMU: The Implementation of the Stability and Growth Pact." *Oxford Economic Review* 14, 3, pp 81-97

Buti, Marco, and André Sapir (1998), *Economic Policy in EMU*. Oxford: Oxford University Press

Bordignon, Massimo (2000)

Cashin, P, (1995), "Government Spending, Taxes, and Economic Growth." IMF *Staff Papers* 42, 237-69

Delors Report (1989), Report on Economic and Monetary Union in Europe. Committee for the Study of Economic and Monetary Union, Luxembourg: Office for Official Publications of the EC.

Easterly, William, and Sergio Rebelo (1993), "Fiscal Policy and Economic Growth: An Empirical Investigation." *Journal of Monetary Economics* 32, 417-58

European Commission (2000), *Public Finances in EMU 2000*. Brussels

European Commission (2002), Coordination of Economic Policies in the EU: A Presentation of the Key Features of the Main Procedures. *Euro Paper* 45, DG ECFIN

Fölster, Stefan, and Magnus Henrekson (1999), "Growth and the Public Sector: A Critique of the Critics." *European Journal of Political Economy* 15, 337-58

Fuller, Thomas (2002), "Rift widens on EU deficits." *International Herald Tribune* 26 September 2002

Gemmel, Norman, and Richard Kneller (2002), "Fiscal Policy, Growth and Convergence in Europe." European Economy Group working Paper 14/2002, University of Madrid.

Giavazzi, Francesco, and Marco Pagano (1990), "Can Severe Fiscal Contractions be Expansionary?" *NBER Macroeconomics Annual* 75-116

Harden, Ian J., Robert Brookes, and Jürgen von Hagen (1995), "How to Avoid Consolidation Fatigue." *European Brief* 3:2, 26-29

Hallerberg, Mark, Rolf Strauch, and Jürgen von Hagen (2001), "Forms of Governance and the Design of Fiscal Rules in the EU Countries 1998-2000." Mimeo, ZEI University of Bonn

Kneller, Richard (2000), "The Implications of the Comprehensive Spending Review for the long-run growth rate: A view from the literature." *National Institute Economic Review* 171, January, 94-105

Kneller, R., M. F. Bleaney, and N. Gemmel (1999), "Growth, Public Policy, and the Government Budget Constraint: Evidence from OECD Countries." *Journal of Public Economics* 74, 171-90

Perotti, Roberto, Jürgen von Hagen, and Rolf Strauch (1998), Sustainability of Public Finances London: CEPR

Sargent, Thomas, and Neill Wallace (1981), "Some Unpleasant Monetarist Arithmetic." Federal Reserve Bank of Minneapolis *Economic Review*

Stark, Jürgen (2001), "Genesis of a Pact." In: Anne Brunila, Marco Buti and Daniele Franco (eds.), The Stability and Growth Pact. Houndmills: Palgrave.

Strauch, Rolf, and Jürgen von Hagen (1999), "Tumbling Giant. Germany's Experience With the Maastricht Criteria." In

Strauch, Rolf, and Jürgen von Hagen (2001) „Fiscal Consolidations: Quality, Economic Conditions, and Success." *Public Choice* 109, 327-46

Tanzi, Vito, and H. H. Zee (1997), "Fiscal Policy and Long-run Growth." IMF *Staff Papers* 44, 179-209

von Hagen, Jürgen (1992), "Fiscal Arrangements in a Monetary Union - Some Evidence from the US." in: Don Fair and Christian de Boissieux (eds.), Fiscal Policy, Taxes, and the Financial System in an Increasingly Integrated Europe Deventer: Kluwer Academic Publishers.

Figure A: Fiscal Stance 1998-2002

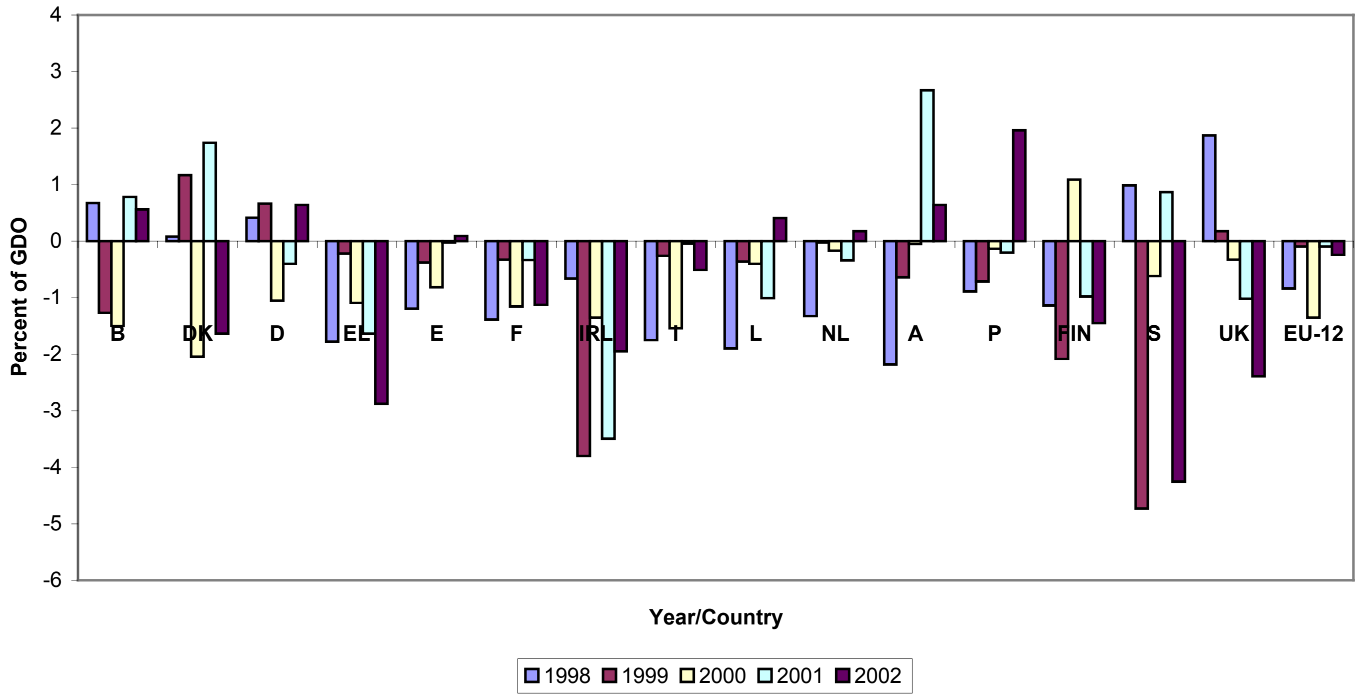


Figure 1: Fiscal Adjustment

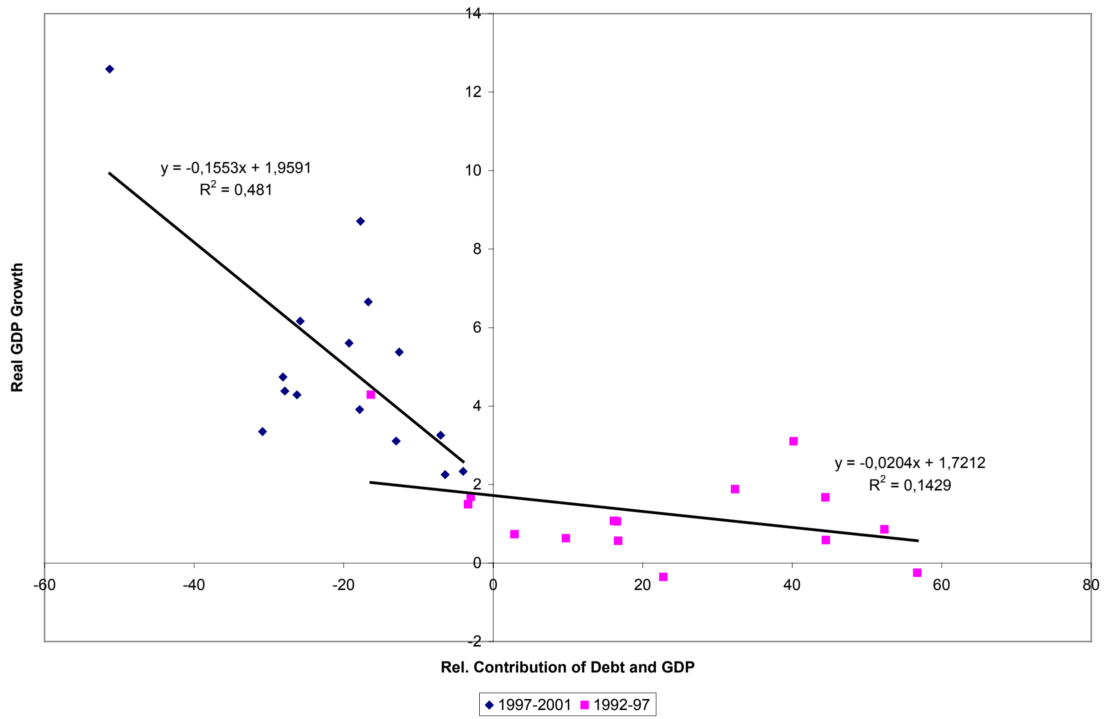


Figure 2: Change in Debt Ratio

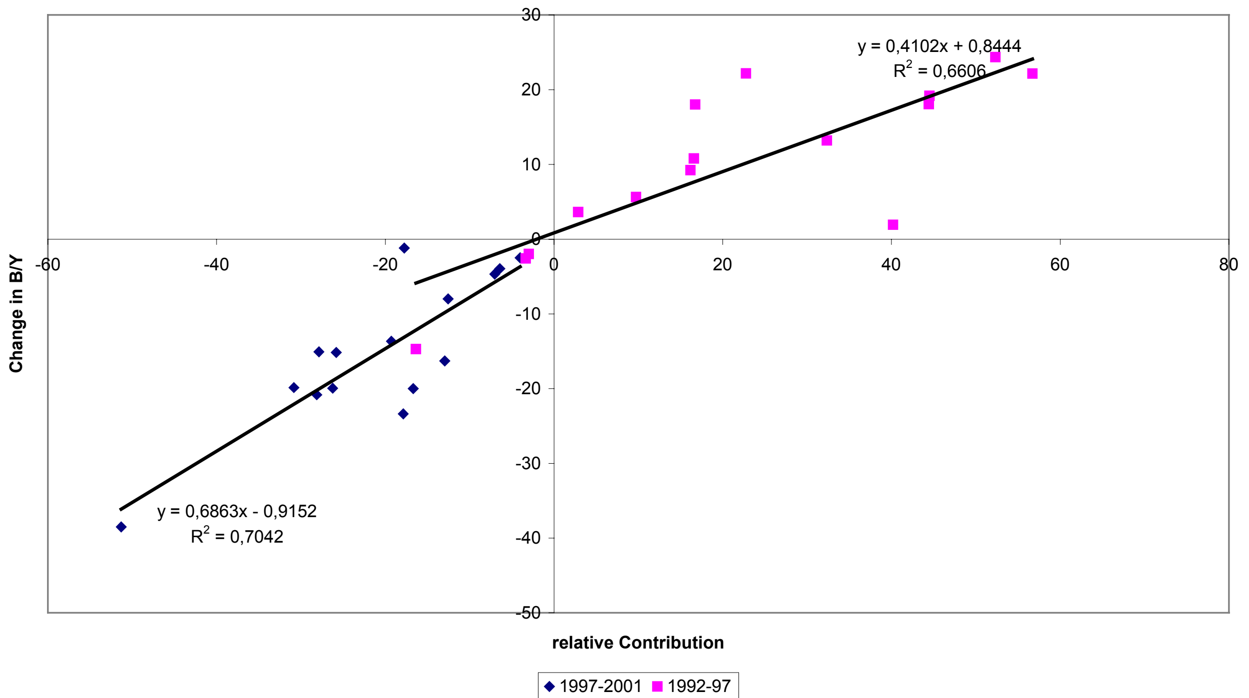
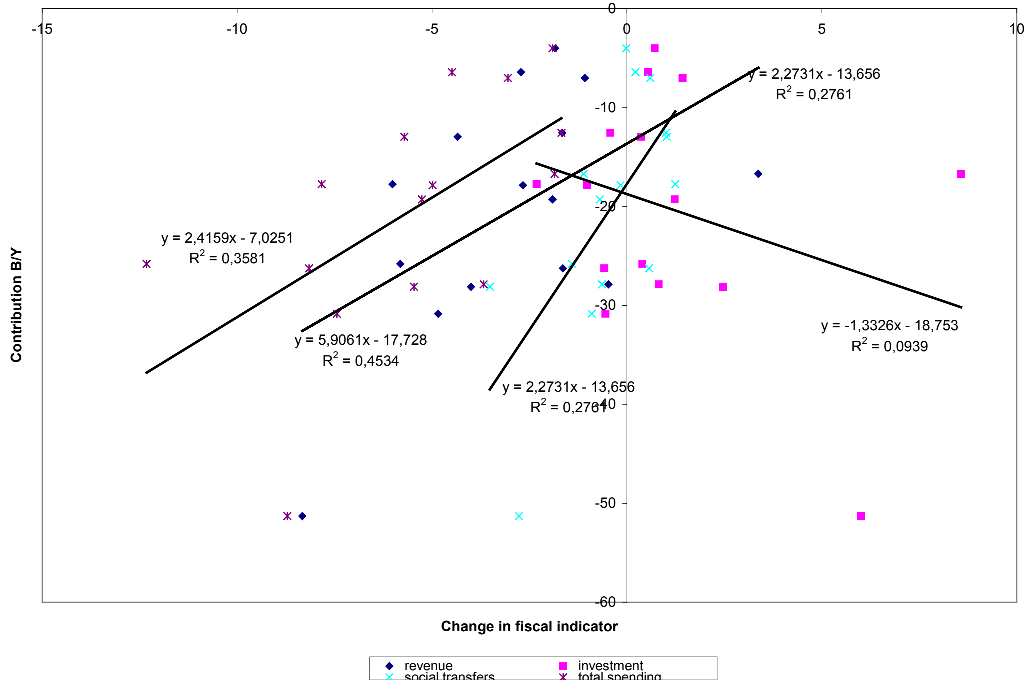


Figure 3: Fiscal Adjustments



Y

Figure 5: Spending Structure

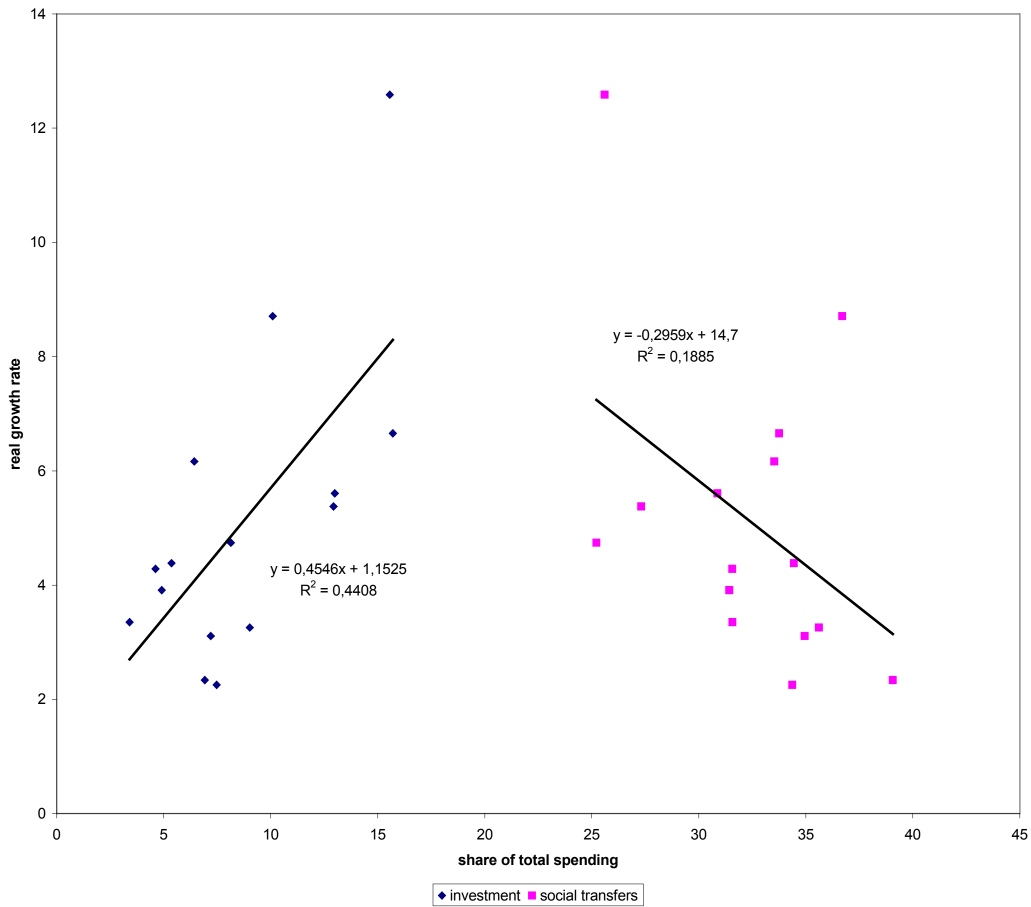


Figure 6: Fiscal Adjustment and Growth