Enforcement and the Stability and Growth Pact: How Fiscal Policy Did and Didn't Change under Europe's Fiscal Framework

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Abstract

Although some have essentially written off the Stability and Growth Pact after a number of recent travails, a review of the evidence suggests that it has been a success in numerous European Union countries, especially in terms of guiding them towards underlying balance. These countries tended to be smaller, more volatile, and to rely on a form of fiscal governance that emphasizes fiscal rules and contracts. Since most of the new members share these characteristics, it is important that the external anchor function of the SGP be retained. The recent changes to the Pact—especially those pertaining to the preventive arm, which deals with medium-term fiscal objectives—need to be assessed in this light. Implementation will be key. But enforcement of the SGP is essentially in the soft law domain, which means that countries ultimately need to possess to right incentives to accept its precepts. In this regard, domestic governance reforms that increase the reputational costs for non-compliance are most useful, and primary among these is the establishment of independent fiscal councils that vet policies.

I. Introduction

1. **The Stability and Growth Pact (SGP), Europe's seven-year old fiscal framework, has faced major enforcement hurdles.** Many countries, including the largest members of EMU, did not follow the dictum which called for countries to strive for underlying fiscal balance over the cycle. Nor were they fully successful in keeping their deficits below the crucial 3 percent of GDP benchmark. Problems also abounded on the procedural side. In a number of high profile cases, the ECOFIN Council[1] elected not to follow the Commission's recommendations. Indeed, the Pact fell into procedural limbo in November 2003 when a divided Council placed the procedures against France and Germany in abeyance, a decision which was subsequently invalidated by the European Court of Justice. Many commentators believed the Pact was dead, having lost legitimacy. They decried its purported mechanistic nature and lack of adequate economic underpinnings. From this quandary, however, member states agreed to a significant SGP reform package in 2005, which tries to account for these problems. The Pact remains alive.

2. **Enforcement has always been the Achilles' heel of the SGP.** This observation is not new. Kopits and Symansky (1998) include enforceability in their core characteristics of a good fiscal rule—the others being well-defined, transparent, simple, flexible, adequate relative to the final goal, consistent, and underpinned by structural reforms. Observers such as Buti, Eijffinger, and Franco (2003) assign the lowest marks to enforcement when gauging the SGP framework against these criteria. Inman (1996) argued that, to be effective, a deficit rule needed four key characteristics: it should rely on ex post, not ex ante accounting; it should be constitutionally grounded; there should be open enforcement by a politically independent agent able to impose significant penalties; and it should be difficult to amend. Against this template, the SGP fares reasonably well, except for enforcement.

3. **Against this backdrop, this paper asks how the SGP can be made more enforceable.** Focusing only on independent enforcement is too narrow. Instead, this chapter explores the different incentives of countries to respect the SGP's tenets, both preventive and dissuasive. The chapter is structured as follows: Section II explores the rationale for fiscal rules in a political-economy framework. Section III provides an overview of the SGP itself. Following from this, the next part (Section IV) discusses the experience of countries living under the fiscal framework, especially after the SGP came into effect. Section V is concerned with why some countries coped better with the SGP than others, and offers some empirical results to that effect. With this in mind, Section VI asks how the SGP can be made more enforceable, especially in the context of an expanded union. Section VII concludes.

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[1] The decision making forum for the EU's finance and economics ministers.

II. The Political Economy of Fiscal Rules

4. **Fiscal rules in a monetary union can serve a dual purpose—remedying deficit biases in domestic policymaking and fostering policy coordination between countries**. Drawing a parallel with monetary policy, an effective way to attack the politically-induced deficit bias—a major impediment to medium and longer-term fiscal discipline in many countries—would be to adopt a rules-based fiscal framework that subverts the discretion of policymakers and fosters the adoption of credible, time consistent policies. Moreover, rules can play a crucial role in coordinating fiscal policies across different jurisdictions, especially by reducing detrimental spillovers. The architects or EMU were particularly mindful of the supranational dimension.

5. **A starting point is to recognize that the political architecture can distort fiscal policy.** Indeed, a principal argument for fiscal rules stems from the fact that democratically elected governments seem to have a built-in bias towards excessive deficits and debt. This bias can be traced to a number of different political economy sources.

- First, by the logic of the standard *common pool model*, politicians who represent different groups and vested interests have no incentive to constrain their spending demands given that the costs are shared by the population as a whole. Politicians can represent different geographical regions, as in the pork-barrel approach to spending frequently associated with the United States, or different social groups in society, more common in the European context. In a dynamic environment, this externality can explain not only excess spending, but also deficit biases and delayed stabilization (Velasco, 1999).

- Second, politicians may be more *myopic* than the general public, especially if they are concerned with securing re-election. Opportunistic politicians will focus on short-term electoral gain, discounting the longer-term effects of running up debt. In this vein, a deficit bias can emerge from the tendency to loosen fiscal policy prior to an election, and to engage in other short-term, time inconsistent, policy actions. Voters may also fail to fully understand the intertemporal budget constraint, such as the full extent of the fiscal burden imposed by aging.

6. **Evidence of politically-induced suboptimal fiscal policy at the national level in Europe is manifold.** Optimal fiscal policy is frequently viewed through the prism of intertemporal tax smoothing, with the net present value of spending equal to the net present value of revenues. With this in mind, the budget is maintained in structural balance but deficits can arise from the free play of automatic stabilizers. However, Alesina and Perotti (1995a) argued convincingly that the differing fiscal outcomes across industrial countries, particularly in the 1970s and 1980s, could not be explained by prevailing economic theories absent political economy factors. Indeed, the literature shows that a plethora of inter-related factors—large and disparate coalitions, a high number of spending ministers, proportional electoral systems, electoral uncertainty, and short government duration—can all act to feed the deficit bias and generate sub-optimal fiscal policy (Roubini and Sachs, 1989; Grilli,

Masciandaro, and Tabellini, 1991; Alesina and Perotti, 1995b; Kontopoulis and Perotti, 1999; Annett, 2002; de Haan, Sturm, and Beekhuis, 1999). Moreover, electoral considerations affected fiscal policy outcomes across European democracies (Alesina, Roubini, and Cohen, 1999), and these seemed most pronounced in the EU (Tujula and Wolswijk, 2004).

7. **In particular, the kind of fragmented governments associated with electoral systems characterized by proportional representation lend themselves to the common pool problem.** In such an environment, it can be tough to instill fiscal discipline within a coalition as each party has its own vested interests and enforcement mechanisms are weak. Weak budgetary institutions, reflected in a fragmented budgetary process, can also exacerbate the deficit bias. The tendency of spending ministers not to internalize the costs of overspending can be curbed by effective budgetary institutions which promote budgetary centralization and reduce the degree of fragmentation (Von Hagen, 1992; Von Hagen and Harden, 1996).

8. **A politically-induced deficit bias may be even greater in a monetary union.** Adopting a common currency means that exchange rate risk and the associated interest rate risk premium is no longer operable, lessening the disciplining effect of fiscal policy. In an area-wide capital market, the ability to pass on at least some of the costs of profligate fiscal policy to other members can exacerbate the deficit bias and lead to a common pool problem for the monetary union as a whole. This could raise area-wide interest rates and generate inflationary pressures, all of which would put pressure on the common monetary policy framework. Moreover, price stability could be jeopardized if the monetary policymaker faces pressure to lower interest rates and inflate away the debt. Also, a country running into fiscal difficulties could be bailed out by other countries or by the central bank purchasing its debt, especially if this path would stave off a banking system crisis.

9. **In tandem with the introduction of the overarching fiscal framework, a number of European countries adopted institutional reforms designed to overcome the common pool problem in fiscal policy.** OECD (2005) notes that budgetary institutions have improved in EU countries over the past decade or so, and that the fiscal framework was a contributory factor in some cases. In particular, more countries are moving toward "best practices" in the sense of medium-term budgetary frameworks, prudent macroeconomic projections, and top down budgeting. Progress has been greatest among the smaller countries. Others have shown that budgetary institutions are more centralized and less fragmented that they were in the early 1990s, which should ease the deficit bias (Hallerberg, Strauch, and von Hagen, 2004).

10. **There are a number of ways to facilitate budgetary coordination.**[2] First, the common pool problem can be overcome through the choice of an appropriate domestic

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[2] See von Hagen (1998); Hallerberg and von Hagen (1999); Hallerberg, Strauch and von Hagen (2001); Hallerberg, Hallerberg, Strauch and von Hagen (2004); von Hagen, (2005).

agenda-setter. For example, the finance minister may be granted a leading role in the budget process, from negotiation through design, implementation, and monitoring. This form of fiscal governance is referred to as *delegation*. Budgetary coordination can also be achieved through *commitment*, whereby the different parties negotiate a "fiscal contract" involving strict budget targets. Such targets typically take the form of binding spending commitments for the individual ministries. Whereas delegation countries attempt to solve the common pool problem by granting a leadership role to one player, commitment countries typically rely more on various formal rules to maintain the fiscal contract. There is also a hybrid case, or a *mixed* system, whereby the ideal solution would look like a cross between the two polar cases of delegation and commitment—the finance minister is granted a strong role in setting the budget, and this is followed by a negotiated agreement with parliament (Hallerberg, 2004).

11. **The choice between delegation and commitment technologies seems to be related to the electoral system** (Hallerberg and von Hagen, 1999; von Hagen, 1998). By this reasoning, delegation is seen as more suited to single-party governments, or governments where coalition partners are close to each other ideologically, where there are few policy differences on the budget. The ultimate sanction for a non-complying spending minister is dismissal from office. Even without going this far, the finance minister's first-among-equals position, with the backing of the prime minister, can be used to ensure compliance. It is unlikely that coalition partners (especially in a large or an ideologically disparate coalition) will agree to vest a single agent with agenda-setting power. In such a case, commitment is the more logical choice, and the threat of breaking up a coalition serves as the enforcement mechanism. Finally, the mixed system may work well with single party minority governments, where the budget is set by one party, and then negotiated with the opposition to secure passage through parliament.

12. **Best practices differ between delegation and commitment countries.** Delegation states tend to cede authority in both setting and implementing the budget to a single agent, such as the finance minister. Commitment states rely more on clear multi-annual budget plans and fiscal rules to deal with unexpected shocks during the implementation of the budget. Formal rules are not as important in delegation states. For mixed systems, there could be a budget pact between the government and the opposition, as well as fiscal rules to deal with unexpected shocks to avoid the temptation to "buy" votes from the opposition to remain in power (Hallerberg, Strauch, and von Hagen, 2001).

13. **Countries have engaged in institutional reform using both delegation and commitment strategies.** Based on detailed case studies, Hallerberg (2004) classifies the EU countries by forms of fiscal governance over the past two decades (Table 1). Historically, most EU countries have not attempted to coordinate budgetary institutions, a system Hallerberg (2004) refers to as *fiefdom*. Throughout the 1980s and early 1990s, however, more and more countries began to adopt reforms. In some cases, this preceded the Maastricht fiscal framework, but in other cases, the need to get the fiscal house in order to qualify for EMU may have been a motivating factor (Belgium, Italy, Greece). Even some of those countries with long-standing commitment technologies strengthened their institutions in the 1990s (Finland, Netherlands). Large countries like France, Germany, and the United Kingdom have

maintained stable delegation technologies over the past few decades; they were joined by Italy (1996), Greece (1997), Austria (2000), and Spain (2001). Most of the other smaller countries adopted commitment. Finally, Portugal is seen as the one country which still maintains a fragmented budget system.

Table 1. Fiscal Governance in the European Union, 1980-2004

Country	Governance form
Austria	Fiefdom until 1986; Commitment 1987-94; Fiefdom 1995; Commitment 1996-97; Fiefdom 1998-99; Delegation 2000-04.
Belgium	Fiefdom until 1992; Commitment 1993-04.
Denmark	Fiefdom until 1981; Mixed 1981-2004.
Finland	Commitment, strengthened mid-1990s.
France	Delegation.
Germany	Delegation.
Greece	Fiefdom until 1996; Delegation 1997-2004.
Ireland	Fiefdom until 1987; Mixed 1988-91; Commitment 1992-2004.
Italy	Fiefdom until 1995; Delegation 1996-2004.
Luxembourg	Commitment.
Netherlands	Fiefdom until 1982; Commitment 1983-2004, strengthened 1994.
Portugal	Fiefdom.
Spain	Fiefdom until 1993; Mixed 1994-2000; Delegation 2001-04.
Sweden	Fiefdom until 1996; Mixed 1997-2004.
United Kingdom	Delegation.

Source: Hallerberg (2004).

14. **There is some evidence that the effectiveness of fiscal rules depends on the quality of underlying domestic institutions.** Fiscal rules can be particularly effective if complemented by adequate domestic budgetary institutions (Von Hagen, 2005). Indeed, it was often the pressure from the European fiscal rules that led countries along the path of institutional reform. Looking at the EU in the late 1990s, Hallerberg, Strauch, and von Hagen (2001) argued that the connection between fiscal rules in themselves and budget discipline was not that strong; instead, what seemed to matter more was whether the country adopted rules and procedures appropriate to its type (commitment or delegation).

III. The Stability and Growth Pact: An Overview

15. **The SGP fleshes out the fiscal policy provisions of the Maastricht Treaty.** The Maastricht Treaty, adopted in 1992, provides for a two-pronged fiscal framework—a preventive arm focusing on multilateral surveillance and the avoidance of excessive deficits, and a dissuasive arm addresses gross policy mistakes. In this regard, countries are obliged to keep their deficits under 3 percent of GDP, and their public debt under 60 percent of GDP.[3] The SGP in a narrow sense, introduced in 1998, consists of two regulations that provide detailed guidance on implementing the Treaty framework.

A. The Preventive Arm

16. **The preventive arm deals with maintaining a sound fiscal policy.** It emphasizes economic policy coordination, peer pressure, and multilateral surveillance. The ECOFIN Council is empowered under Article 99 of the Treaty to issue Broad Economic Policy Guidelines and monitor developments in member countries. If it deems that a country's policies are not consistent with the guidelines, it can make recommendations. The first SGP regulation beefs up this surveillance function. It complements the 3 percent of GDP deficit limit by requiring countries to strive for a medium-term "close-to-balance or in surplus" (CBS) objective. This has subsequently been interpreted as a cyclically-adjusted balance requirement. It does not specify a precise fiscal target for each country, although it has been taken to rule out deficits that are systematically larger than ½ percent of GDP over the cycle, the idea being to provide a sufficient cyclical safety margin to allow full operation of automatic stabilizers during downturns without breaching the 3 percent reference value.

17. **Stability Programs form the backbone of the surveillance procedure.** Member states are required to submit annual Stability Programs (Convergence Programs for those countries which have not adopted the euro) which detail progress towards this medium-term goal and the evolution of debt. Based on a Commission recommendation, the Council considers whether the medium-term objective contains a sufficient safety margin, whether the economic assumptions are realistic, and whether the proposed measures are sufficient to achieve the targeted adjustment path. If it chooses, ECOFIN can invite the country to adjust its program. A key feature of the preventive arm is the early warning system, whereby the Council can address a recommendation to a member country to take measures to avoid a possible excessive deficit.

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[3] Breaches of the 3 percent limit would lead to unsustainable debt paths given a nominal growth rate of 5 percent and a starting 60 percent debt ratio.

B. The Dissuasive Arm

18. **The dissuasive arm is charged with ensuring that countries respect the limits on deficits and debt laid down by the Maastricht Treaty.** Article 104 of the Treaty, or the Excessive Deficit Procedure (EDP), describes what happens when countries breach the reference limits. Noncomplying countries are subject to increasingly stringent surveillance under the EDP, which can culminate in the imposition of financial penalties. The second SGP regulation fleshes out the procedure, by detailing each phase in the process, including the timing. One of the goals of this regulation was to speed up the process and allow sanctions to be imposed relatively quickly if the country has not complied with the earlier steps. The original goal was to arrive at the sanctions phase within 10 months. While at the prerogative of the ECOFIN Council, the framers of the SGP wanted to make sanctions "quasi-automatic" for deviant countries (Stark, 2001).

19. **The first step in the EDP is the decision on the existence of an excessive deficit.** A deficit greater than 3 percent of GDP need not trigger the EDP if the excess is deemed to be exceptional, temporary, and close to the reference value. When preparing its initial report, the Commission takes into account whether the deficit exceeds government investment and also considers "all other relevant factors, including the medium-term economic and budgetary position of the member state". The SGP regulation defined exceptional as resulting from "an event outside the control of the member state... which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn". In turn, a severe economic downturn was defined as a fall in real GDP by at least 2 percent. A fall between 0.75 and 2 percent may be exceptional, given supporting evidence. A less than 0.75 percent decline is not. The deficit is temporary if it will "fall below the reference value following the end of the unusual event or the severe economic downturn". The SGP does not define the "closeness" criterion.

20. **If an excessive deficit is deemed to exist, countries are obliged to undertake corrective policies within a defined timeframe.** With the first recommendation (Article 104.7), countries are given a deadline to take "effective action" (originally four months) and to eliminate the excessive deficit (originally a year, barring "special circumstances"). After the allotted time, if the ECOFIN Council feels that the member state is not implementing the measures, or that they are inadequate, or that data indicate that the excessive deficit will not be corrected within the time limit, then it will move on to the next step of the procedure, the enhanced fiscal surveillance under Article 104.9. A second recommendation will be presented, and ECOFIN may request the member state to submit regular reports to monitor adjustment efforts. This stage, and beyond, is only applicable to countries in the final stage of EMU.

21. **Ultimately, a non-complying country can be sanctioned.** If the country is not in compliance with the second recommendation (within two months, under the original SGP), then it could face sanctions (Article 104.11). The Treaty prescribes a range of option for sanctions: requiring the member state to publish additional information before issuing bonds; inviting the European Investment Bank to reconsider its lending policy; requiring the

member state to make a non-interest bearing deposit; and imposing fines. The SGP regulation states that non-interest bearing deposits are required "as a rule".[4] If the excessive deficit has not been corrected in the two years after the deposit was made, it shall be converted into a fine. If, before two years are up, the Council considers the excessive deficit to be corrected, it abrogates the procedure and returns the deposit. Fines are not reimbursed. Interest on deposits, and fines, shall be distributed among member states without excessive deficits (proportional to their share in total GDP).

C. The Reformed Pact

22. **An uneven enforcement record prompted a reform of the SGP.** For a start, early warnings did not live up to expectations. The ECOFIN Council often balked at issuing them, and when it did, they were often ineffective. Moreover, enforcement of the EDP ran into some major hurdles in 2003, as ECOFIN refused to move France and Germany into enhanced fiscal surveillance as recommended by the Commission, one step short of sanctions. It instead placed the EDP against these two countries in abeyance, a decision subsequently invalidated by the European Court of Justice. A resulting procedural impasse prompted the Commission to propose SGP reform. Many had criticized the SGP during this period for adopting too much of a "one-size-fits-all" approach under the preventive arm, failing to adequately account for country-specific sustainability factors. Likewise, critics saw the EDP was too inflexible and unwieldy, not distinguishing enough between policies and the effects of the economy when assessing fiscal developments, and hence lacking legitimacy. In response to the new initiative, ECOFIN adopted revised SGP regulations in mid-2005.

23. **The revised preventive arm endeavors to provide greater flexibility to account for sustainability considerations.** Countries can now set their own medium-term objectives (MTOs) based initially on debt and potential growth (the goal is to incorporate implicit liabilities in the future). Stability Programs should continue to report these MTOs and the accompanying adjustment path for countries not already there. These MTOs can deviate from CBS, but they cannot exceed a deficit of 1 percent of GDP. Countries not at their MTOs should target adjustment of ½ percent of GDP a year, net of one-offs and other temporary measures, and should commit to more adjustment in good times. ECOFIN can still call upon countries to adjust programs, and countries must explain any deviation from their MTO. A further innovation is that countries can deviate from their MTO, or the adjustment path toward the MTO, if they undertake structural reforms expected to yield direct long-term cost savings (including by boosting potential growth). The onus is clearly on countries to provide a quantitative assessment of the impact of these reforms. Moreover, countries are expected to

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[4] The first deposit comprises a fixed component of 0.2 percent of GDP and a variable component equal to one tenth of the difference between the deficit and the 3 percent, in percent of GDP. Each following year, the Council may decide to intensify the sanctions by requiring another deposit (variable component only). No single deposit can exceed 0.5 percent of GDP.

return to their MTO within the program period, and to continue to maintain an adequate safety margin with respect to the 3 percent reference value.

24. **More flexibility is also built into the dissuasive arm, in an attempt to make it more tuned to economic developments.** Reforms include the following:

- The definition of exceptional circumstances is broadened to encompass all periods of negative growth, as well as protracted episodes of slow growth.
- "Other relevant factors" will be given explicit consideration before initiating the EDP. This could mean that a deficit exceeding 3 percent of GDP can escape the EDP altogether. As a caveat, however, these factors can only be taken into account as long as the excess of the deficit above 3 percent is temporary, and it remains close to the 3 percent.
- The internal deadlines for taking effective action have been lengthened (4 months to 6 months for the first recommendation and 2 months to 4 months for the second recommendation).
- The deadline for eliminating an excessive deficit can be extended. While the standard remains the year after identification, or the second year after occurrence, "special circumstances" (which are to be based on an assessment of the "other relevant factors") can be invoked to justify an additional year. In effect, "other relevant factors" can be called upon at any stage in the procedure barring abrogation. But the initial deadline under the EDP should be set so that the country will have to adopt a minimum adjustment of ½ percent of GDP, net of one-offs and other temporary measures. If this ½ percent is deemed sufficient, countries will not require more time.
- The deadline for eliminating an excessive deficit can also be changed within the procedure if adverse economic circumstance arise, as long as countries have taken effective action. In practical terms, this means they will face another recommendation at the same step of the procedure, rather than being forced into the next phase.
- The costs related to pension reforms that transfer contributions from a public pay-as-you-go pillar to a private, fully-funded pillar, can be invoked on a diminishing basis for five years to justify abrogation from the EDP. In other words, 100 percent of the cost will be taken into account in the first year, 80 percent in the second year etc.

IV. Developments Under the Fiscal Framework

25. **EU countries' fiscal records were widely divergent prior to the signing of the Maastricht treaty.** Before the advent of the rules-based framework, the effects of discretion manifested themselves through various forms of sub-optimal policies in numerous countries. Many countries ran persistent and unsustainable deficits that fed through to rapid public debt accumulation—countries like Belgium, Greece, Ireland, and Italy saw their debt spiraling

above 100 percent of GDP during the 1980s and early 1990s with deficits hovering around 10 percent of GDP. At the same time, however, deficits in core countries like France and Germany had traditionally been kept in check, and public debt accumulation remained moderate.

26. **Historically, fiscal policy in EU countries tended to be highly procyclical, muffling in part or in full the operation of automatic fiscal stabilizers** (European Commission, 2001). Procyclicality tended to be especially pronounced during good times (Jaeger 2001; Debrun and Faruqee, 2004), and was seen as a leading cause of debt accumulation. Factors that facilitated procyclicality included a large PAYG system and a sizeable lower government sector (Jaeger, 2001), dispersed political power (Lane, 2003), and the prevalence of coalition governments (Skilling, 2001). Again, politically-induced distortions led to short-term and sub-optimal fiscal policy.

27. **The ratification of the Maastricht treaty spurred countries into action as they scrambled to meet the deficit criterion.** Most countries underwent substantial fiscal adjustment in the 1990s (see IMF, 2001; von Hagen, Hughes Hallett and Strauch, 2000; OECD, 2005). Comparing the Maastricht era (1992-98) with the period 1980-91 shows an average improvement in the cyclically-adjusted primary balance—the measure of discretionary fiscal policy that will be used throughout this paper— of almost 3 percent of GDP among the euro-area countries (excluding Luxembourg), and 2 percent of GDP if the three EU15 members that have not adopted the euro are included (see Table 2). This includes some substantial adjustment in countries with historically undisciplined fiscal policy, including Belgium, Ireland, Greece, and Italy. As a result, by the onset of EMU in 1999, almost all of the present euro-area membership had succeeded in the bringing their deficits below 3 percent of GDP.

28. **But experience under the SGP was more mixed.** One the one hand, the average overall balance among euro area countries improved by 3½ percentage points during the SGP period (1999-04), a greater improvement than under Maastricht, allowing the area as a whole to chalk up a better fiscal performance during these years than in other major currency areas. But this masks a distinct lack of underlying adjustment, given that the average cyclically-adjusted primary balance among euro-area countries did not budge between the earlier (Maastricht) and later (SGP) periods. The positive effect of Maastricht on Europe's public finances appeared to evaporate after the onset of EMU. Indeed, the cyclically-adjusted primary balance deteriorated in fully half of the euro area countries at this time. In only three countries did the adjustment in the SGP period supersede that undertaken under Maastricht.[5] Many countries also made scant progress reducing their debt, especially the high-debt ones (Greece, Italy), while the debt ratio rose steadily in others (France and Germany in particular). Looking at the EU-15 improves the picture only marginally.

[5] Interesting, the three non-euro-area countries are also in this camp, perhaps because adjustment during the Maastricht era was less urgent for them.

29. **The goal of CBS remained elusive for many countries.** Many have argued that the standstill under the SGP reflected adjustment fatigue, especially after countries had qualified for EMU and the imminent threat of exclusion had passed (Hughes-Hallet, Lewis, and von Hagen, 2004; von Hagen, 2005). But this is only part of the story, given the wide variations in starting positions. By the end of 2004, only half of the euro area countries could be deemed as CBS, defined as a minimum ½ percent cyclically-adjusted deficit—Belgium, Finland, Ireland, Netherlands, and Spain (see Figure 1).[6] Some of these countries could therefore afford to loosen, or to undertake minimal adjustment, and still comfortably meet CBS. Others however, remained far off, including France, Germany, Greece, Italy, and Portugal. As a result, these five countries ended up posting deficits in excess of 3 percent, pushing them into the EDP. (Figure 1).[7] Clearly, these countries in particular failed to undertake sufficient adjustment in the SGP years.

30. **One clear pattern, noted by many, is that a gulf opened up under the SGP between large and small countries** (Annett and Jaeger, 2004; Buti and Pench, 2004; OECD, 2005; von Hagen, 2005). With the large countries seemingly especially unwilling to push for underlying balance, the Pact seems to have worked well for a core group of smaller countries, who stuck to their commitments. Figure 2 shows the divergent trends between a weighted average of Germany, France, and Italy on the one hand, and a weighted average of the other euro-area countries on the other. Ironically, the traditional bastions of fiscal stability in Europe—France and Germany—were shunted to the bottom of the pack. Indeed, fiscal behavior in these countries seemed largely untouched by the SGP, as overall and structural balances in the SGP period were remarkably similar to those in the pre-Maastricht era, at a time when such a position was the mark of a solid performer.

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[6] Denmark and Sweden had also achieved a CBS position.

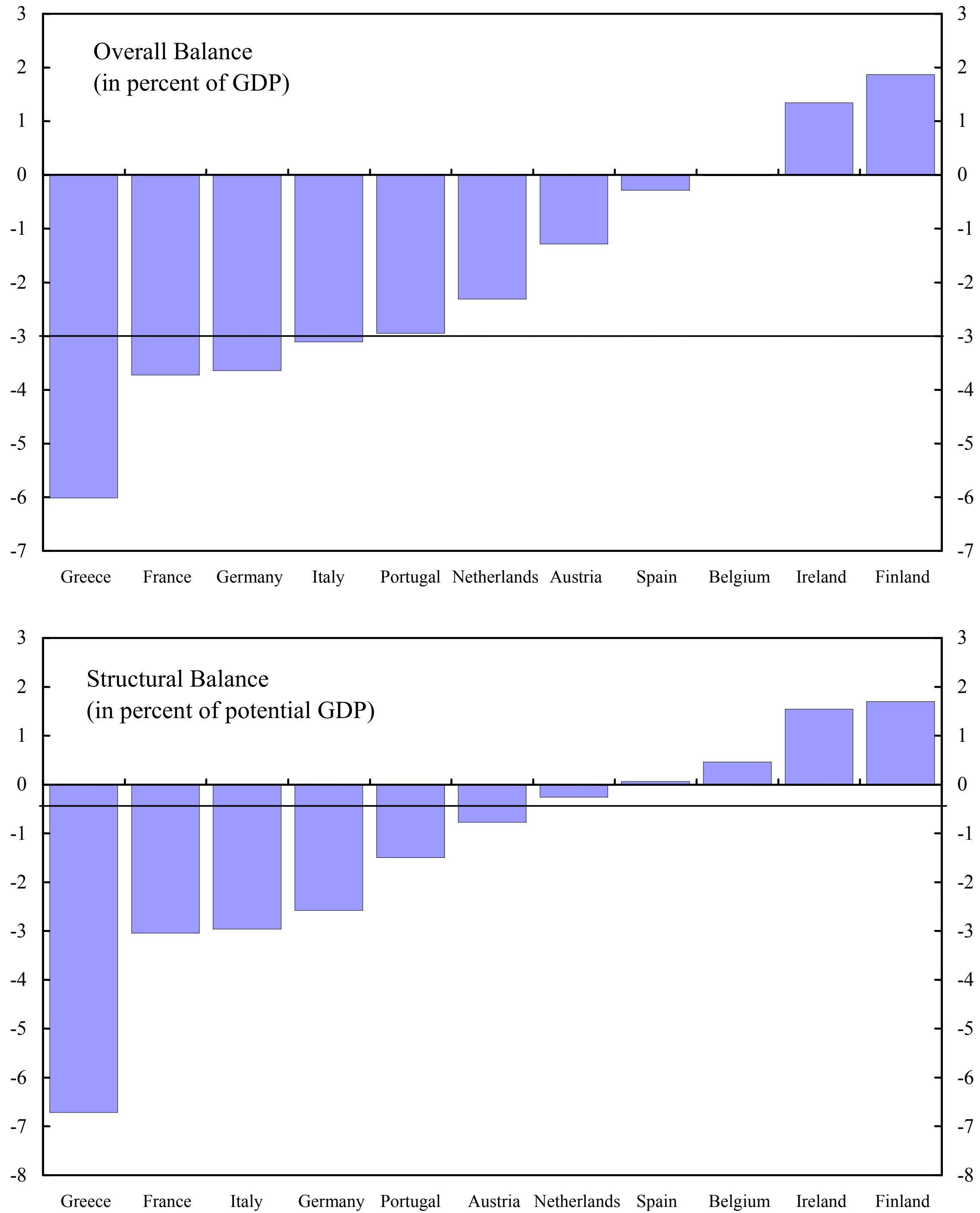
[7] From outside the euro area, the UK also posted a deficit in excess of 3 percent in 2004.

Table 2. Fiscal Developments in the European Union, 1980-2004

	Overall balance			Cyclically-adjusted balance			Cyclically-adjusted primary balance			Gross debt		
	1980-1991	1992-1998	1999-04	1980-1991	1992-1998	1999-04	1980-1991	1992-1998	1999-04	1980-1991	1992-1998	1999-04
Austria	-3.0	-3.6	-1.1	-2.8	-3.7	-1.4	-0.5	-0.5	1.2	50.2	63.3	65.5
Belgium	-10.1	-4.5	0.1	-9.3	-3.3	0.2	0.2	5.5	6.0	117.3	130.7	105.5
Finland	3.6	-3.6	3.8	3.0	1.7	3.8	1.8	2.4	4.5	15.6	53.0	44.7
France	-2.3	-4.4	-2.6	-1.9	-3.8	-2.5	0.0	-0.7	0.2	29.6	52.0	60.1
Germany	-2.2	-2.8	-2.3	-2.0	-2.3	-2.6	0.3	0.7	0.2	39.7	54.0	62.0
Greece	-9.8	-8.4	-4.2	-9.6	-7.2	-4.4	-4.3	3.5	2.0	51.5	105.7	111.0
Ireland	-8.1	-0.9	1.5	-7.7	0.1	0.6	-1.7	3.8	1.2	95.5	78.6	36.2
Italy	-11.1	-7.2	-2.4	-10.6	-6.3	-2.8	-3.0	4.1	2.7	80.6	119.5	109.6
Netherlands	-4.7	-2.6	-0.8	-4.4	-2.9	-1.4	-0.4	1.6	1.4	67.5	74.7	55.7
Portugal	-6.7	-5.4	-3.1	-5.8	-5.2	-3.2	0.3	0.8	-0.1	50.7	59.6	57.3
Spain	-4.4	-5.0	-0.4	-3.9	-4.0	-0.5	-2.1	0.3	2.2	35.5	61.4	56.2
Average EU-11	-5.3	-4.4	-1.0	-5.0	-3.4	-1.3	-0.8	1.9	2.0	57.6	77.5	69.5
Denmark	-2.0	-1.3	2.3	-1.8	-0.3	2.2	2.2	2.7	3.9	60.4	71.1	48.8
Sweden	-1.4	-5.5	1.8	-0.8	-2.1	1.9	-0.9	-1.3	2.6	51.7	71.3	54.3
UK	-2.3	-4.8	-0.5	-1.6	-4.0	-0.9	1.7	-1.2	1.1	46.5	48.0	40.9
Average EU-14	-4.6	-4.3	-0.6	-4.2	-3.1	-0.8	-0.4	1.5	2.1	56.6	74.5	64.9

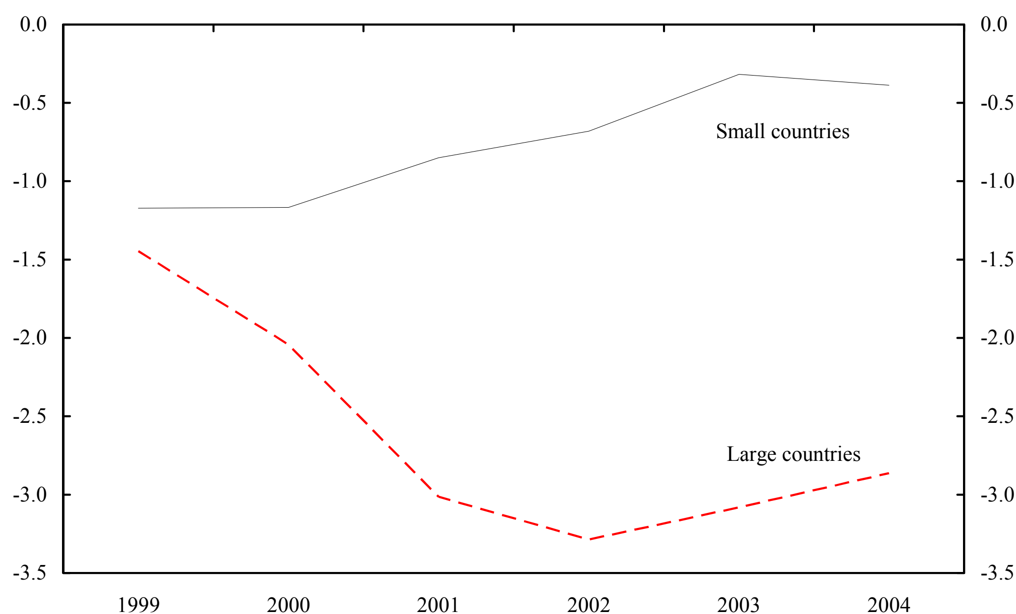
Source: OECD.

Figure 1. Overall and Structural Balance in the Euro Area, 2004.



Source: OECD.

Figure 2. Structural Balance in Large versus Small Countries in the Euro Area, 1999-2004
(in percent of potential GDP) 1/



Sources: OECD.

1/ Large countries comprise Germany, France, and Italy.

31. **The evidence pertaining to the response of fiscal policy to the cycle under the fiscal framework is more uncertain.** In contrast with past patterns, various studies have shown that procyclicality was more muted after the adoption of the fiscal framework. Gali and Perotti (2003), for example, show that the response of discretionary policy to the output gap switched from being procyclical prior to Maastricht to essentially acyclical in its aftermath. Some tell a similar story with the SGP, especially when the emphasis shifted from nominal to cyclically-adjusted balances (Fatas and others, 2003). Certainly, looking over the past business cycle, the structural fiscal balance of the euro area as a whole was far more stable than the overall deficit, as automatic stabilizers were allowed to operate unhindered, especially in the downturn (Annett and Jaeger, 2004). But others have argued that fiscal policies actually became more procyclical, defined in terms of the response of the cyclically-adjusted primary balance to the output gap, after the introduction of the euro as the tendency to loosen in good times vanished and countries held back on adjusting in bad times (Debrun and Faruqee, 2004). Likewise, Balassone and Francese (2004) held that fiscal balances deteriorated in downturns and did not improve in upturns, and that this pattern was not changed with the onset of the fiscal framework.

32. **Certainly, some countries missed the opportunity to adjust during good times.** A key failing the SGP in its early years was its inability to prompt countries to attain CBS during the periods of high growth. From 1999-00, the average cyclically-adjusted primary balance among euro-area countries declined by almost ½ percent of GDP; adding the three non-euro-area members mitigates this only a little (Table 3). In fact, Finland was the only country to undertake substantial adjustment over this period. All in all, fiscal policy was loosened in seven countries, and stood still in numerous others. A more countercyclical pattern emerged during the downturn (2001-04), with the average euro-area cyclically-adjusted primary balance falling by more than 1 percent of GDP. At this time, eight euro area countries, and ten EU countries, recorded structural fiscal deteriorations. Belgium, Ireland, Germany, Greece, and Italy all loosened in both phases of the cycle. In terms of CBS requirements, the first two countries could afford to, while the three latter ones could not.

Table 3. Fiscal Adjustment under the SGP

(change in cyclically-adjusted primary balance)

	Good Times (1999-00)	Bad Times (2001-04)	Overall (1999-04)
Austria	-0.2	1.7	1.5
Belgium	-1.4	-0.6	-2.0
Finland	3.2	-4.9	-1.7
France	0.0	-1.5	-1.5
Germany	-0.6	-0.9	-1.4
Greece	-2.9	-4.6	-7.6
Ireland	-0.7	-2.0	-2.8
Italy	-1.4	-2.1	-3.4
Netherlands	0.2	-0.1	0.1
Portugal	-0.6	2.4	1.8
Spain	0.0	0.5	0.5
Average EU-11	-0.4	-1.1	-1.5
Denmark	0.2	0.7	0.9
Sweden	0.5	-3.1	-2.6
UK	0.3	-5.2	-4.8
Average EU-14	-0.2	-1.4	-1.7

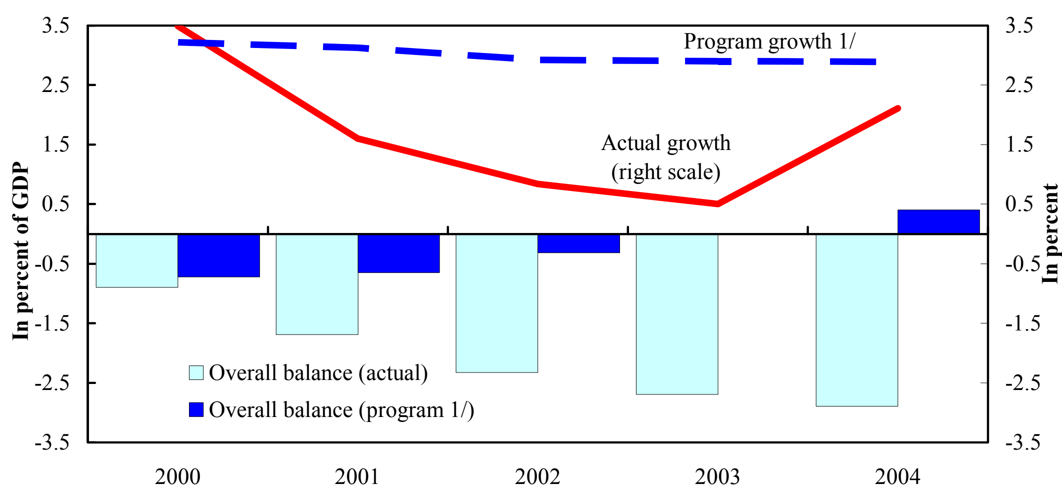
Source: OECD

33. **Looking behind the scenes, many countries adapted to the requirements of the on the surface while at the same time not fully abandoning the legacy of past fiscal profligacy.** Political economy incentives to appear in tune with the SGP while failing to undertake the requisite adjustment came in numerous guises. Indeed, a numerical fiscal rules can often cause a shift from overt to hidden forms of deficit bias (OECD, 2005). The framework does leave in place some incentives toward policies with a short-term bent. The following problems stand out:

- *Overly-optimistic assumptions:* Adjustment often fell far short of what was promised in Stability Programs. Numerous countries relied on overly-optimistic growth assumptions, reducing the pressure to plan substantial medium-term adjustment (Jonung and Larch, 2004; Strauch, Hallerberg, and von Hagen, 2004). This strategy allowed governments to show favorable *ex ante* outcomes, while allowing them to

blame poor *ex post* outcomes on the economy (see Figure 3).[8] In a more sophisticated version of the same strategy, persistently over-optimistic estimates of potential growth made underlying balances look healthier than they were at the time, again leading to looser *ex post* fiscal policy evaluations. As a result, these growth disappointments led to repeated downward revisions of structural balance targets in each Stability Program vintage, with each successive revision pushing the CBS target farther out on the horizon (Figure 4). Hence public debt remained high, and did not decline in line with Stability Program expectations (Figure 5).

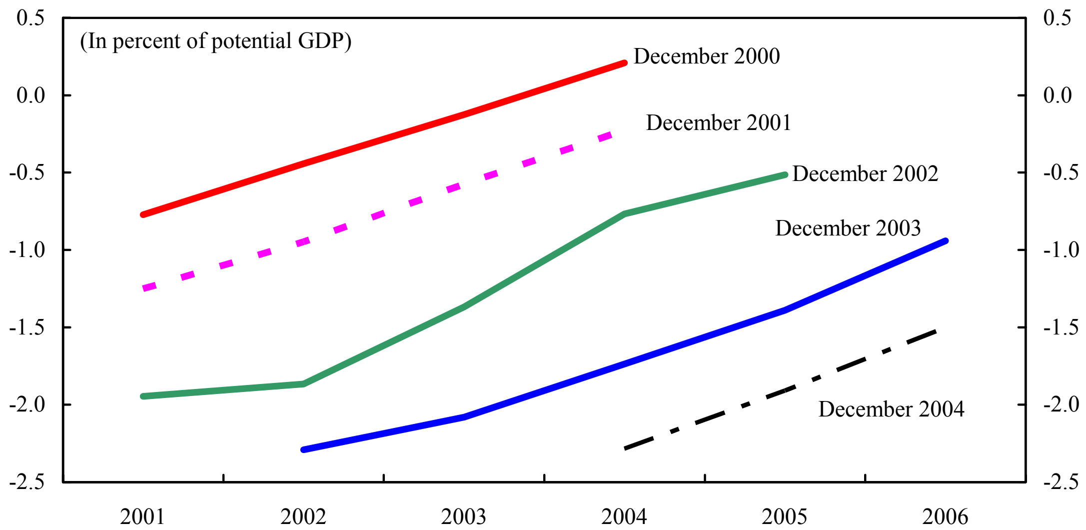
Figure 3. Euro Area: Real Output Growth and Fiscal Balance, 2000-2004



Sources: European Commission; and IMF, *World Economic Outlook.*
1/ December 2000 Stability Programs.

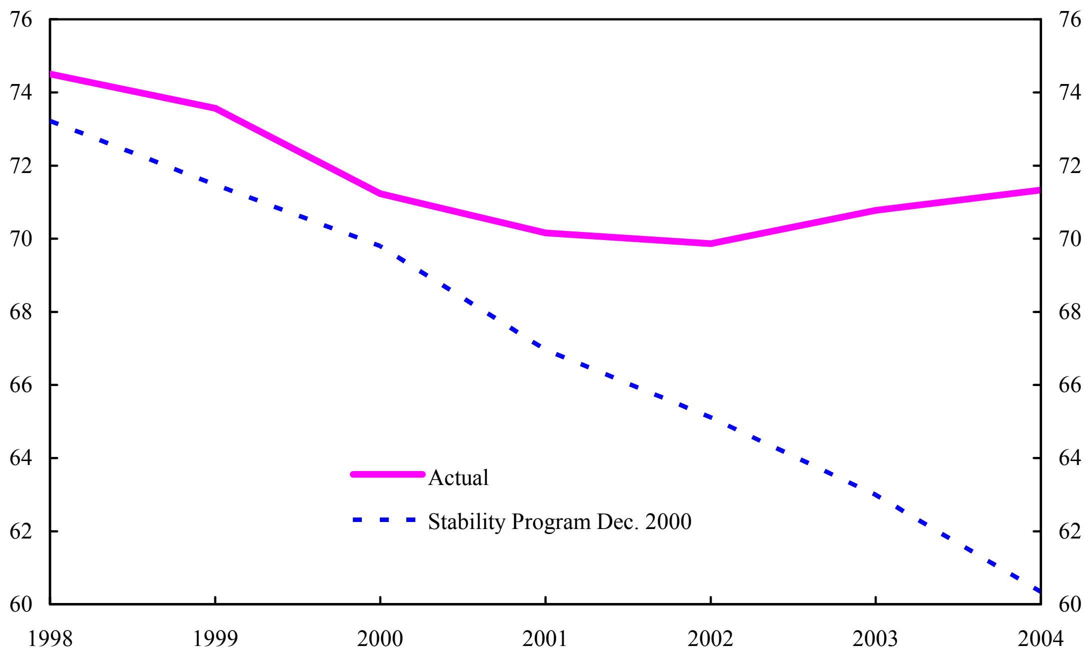
[8] Figure 3 shows the projections the December 2000 Stability Program update for the euro area as a whole, which is a weighted average of the members. Forecasts contained in subsequent Stability Program updates display similar trends.

Figure 4. Euro Area: Shifting Structural Balance Targets in Stability Programs, 2001-2006



Source: European Commission.

Figure 5. General Government Debt, 1999-2004
(in percent of GDP)



Source: European Commission and IMF, *World Economic Outlook.*

- *One-offs, creative accounting, and misreporting:* The emphasis on numerical values, particularly the enshrined 3 percent deficit limit, creates incentives to circumvent the rule without actually undertaking the requisite adjustment.[9] Some countries made substantial recourse to one-offs and fiscal gimmicks over the life of both the Maastricht treaty and the SGP, including Italy, Greece, and Portugal (Koen and van den Noord, 2005). Indeed, the tendency toward one-off measures seems to spreading, as countries focus on getting below, or staying below, the 3 percent limit; in the past year, both France and Germany relied on large one-offs. Gimmicks are more likely when countries approach the 3 percent, or when budgetary institutions are more decentralized (Koen and van den Noord, 2005). A particular form of creative accounting involves the use of stock-flow adjustments that add to debt but not to the deficit.[10] Evidence shows that the introduction of the fiscal framework in Europe was associated with a systematic relationship between deficits and these stock-flow adjustments (von Hagen and Wolff, 2004). Moreover, in some countries there are wide gaps between the accruals deficit, the cash deficit, and the annual change in debt; oftentimes the discrepancies are not transparent (Balassone, Franco, and Zotteri, 2004). In the most blatant examples of this tendency, misreporting of data in Greece and Portugal led to huge *ex post* adjustments of fiscal data.

34. **Moreover, electoral cycles under EMU may have contributed to an expansionary bias in numerous countries.** In particular, governments tended to cut taxes and increase spending as elections approach; this effect was more pronounced in upswings (Buti and van den Noord, 2004). The SGP failed to curb the well-known political budget cycle in Europe. The electoral calendar also happened to be quite full immediately after the expansion in the early years of EMU. In terms of the larger countries, France and Germany both held elections in 2002, as did Italy in 2001. The inability of the SGP to foster adjustment during recoveries may have been related to opportunistic electoral fiscal expansions. It also may have contributed to the refusal of the ECOFIN Councils to issue early warnings to Germany and Portugal in 2002 (OECD, 2005).

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[9] Myopic governments discount the future heavily, meaning that they are more inclined to run down public assets (including the present value of future tax payments). Examples include: privatization, cuts in public investment; cuts in operations and maintenance spending; shifting expenditure and revenue over time; and eating into the net present value of contributions and benefits of an entitlement program (OECD, 2005).

[10] An oft-exploited issue with the accounting framework is that the deficit measure excludes financial transactions. In some cases, such transactions can be questionable, such as when a they are merely disguised capital injections.

V. Explaining Divergent Country Experiences: Empirical Results

35. **Why did the SGP work better for some countries than others?** Despite the many criticisms leveled at Europe's fiscal framework, it cannot be seen as an outright failure. As noted, numerous countries attained underlying balance positions or better. But the SGP failed to spur a number of other countries to undertake the needed adjustment. France and Germany have been under the EDP since 2003. Others (including Italy, Greece, and Portugal) postponed the inevitable through though one-offs and creative accounting. A number of possible explanations have been raised to explain the emerging division between euro-area (and EU) countries when it comes to domestic enforcement of the SGP.

36. **First, some have argued that the SGP is more suited to small countries.** Adherents of this position see it as no coincidence that the largest three members have been the ones facing the greatest difficulty with the SGP. This argument comes in various hues:

- *Political*: Small countries are simply more accustomed to external influences over policy (Von Hagen 1998; Von Hagen, Hughes Hallett, and Strauch, 2000). International organizations and agreements tend to play a greater role in domestic policymaking in smaller countries. Also, as they tend to have less bargaining power, the loss of reputation from violating the fiscal rule is greater (De Haan, Berger, and Jansen, 2003). Small countries could also fear tangible pecuniary losses such as reductions in structural funds. Large countries may view the cost of profligate fiscal policy to be low, given that they suffer little diminution in reputation. Others note that while the Maastricht criteria were fully supported by the large countries, the political ownership of the fiscal rules subsequently shifted to the smaller countries who valued sound fiscal positions, but had little influence with their peers (OECD, 2005).

- *Economi*c: The costs of fiscal consolidation tend to be higher in large countries (Buti and Pench, 2005). According to this Keynesian argument, fiscal multipliers are greater in large countries, which makes consolidation significantly costlier.

This argument is appealing in the sense that it can account for the divergence in fiscal policy between the large and small countries under the SGP (Figure 2), but it cannot explain the sizeable fiscal lapses of two small countries—Greece and Portugal.

37. **Second, the SGP could act as an external anchor for countries prone to macroeconomic volatility.** Such countries are more accepting of a rules-based framework. Especially in the context of EMU, such a fiscal framework can prove especially valuable to anchor policies and garner credibility. In this sense, the SGP can be seen to take over the role once played by exchange-rate coordination mechanisms such as the Bretton Woods system. Moreover, there is a noted tendency for countries facing greater external risk to compensate in the form of a larger government (Rodrik, 1998), which in turn can have a stabilizing effect on output (Fatas and Mihov, 2001). Absent a disciplining device on the fiscal balance, however, the provision of social insurance could bolster the tendencies towards time

inconsistent fiscal policies and lead to a deficit bias. In this context, the goal of underlying balance, allowing free play to automatic stabilizers, is especially appealing.

38. **Third, the SGP could be more suited to countries that adopt the commitment rather than the delegation form of fiscal governance** (Hallerberg, 2004). With its emphasis on multi-annual targets and a regular review procedure, the SGP fits snugly with the numerical contracts approach associated with commitment states, but not so well in states that rely on domestic governance institutions. The main difference is that the mechanisms of the SGP rely on an external agent to enforce the fiscal contracts (von Hagen, Hughes Hallett, and Strauch, 2000). In delegation countries, fiscal policy will be based on domestic considerations and constraints, with fewer incentives to abide by SGP rules. In commitment states, on the other hand, the SGP reinforces domestic fiscal rules, and can provide an added impetus for all sides to live up to their side of the bargain. It can strengthen the commitment technology when external enforcement is superior to the domestic variety. This is consistent with the argument that the effectiveness of fiscal rule is contingent on the quality of underlying institutions, if it is accepted that commitment adapts naturally to the SGP environment.

39. **The advantage of the fiscal governance hypothesis is that it can explain the behavior of all of the relatively weak performers under the SGP.** France, Germany, Italy, Greece are all delegation countries while Portugal stood out at this time as the one country which did not reform its budgetary institutions in either a commitment or a delegation direction. Certainly, fiscal policy behavior in the two long-standing delegation countries (France and Germany) has not changed much under the fiscal framework, suggesting that it has not made much on an impact on the prevailing form of fiscal governance. For Italy and Greece, the adoption of delegation during the Maastricht era coincided with dramatic deficit reduction, but adjustment tapered off under the SGP.

40. **These explanations are by no means mutually exclusive.** Small countries tend to be more open, and more prone to external shocks (Alesina and Wacziarg, 1998). There is also a noted tendency for small, open economies to adopt proportional political systems, which in turn makes commitment more suitable (Rogowski, 1987). Moreover, it was the mainly the small countries that reformed their budgetary institutions, typically in the 1990s, to aid in achieving fiscal discipline. Indeed, some have argued that the large country- small country dichotomy that emerged was due to the fact that the large countries did little to improve their budgetary institutions (von Hagen, 2005). So the SGP could be suited to a subgroup of countries, that (i) are small and more likely to accept an external constraint; (ii) have the potential for macroeconomic volatility and so appreciate an external anchor; and (iii) adopt the commitment form of fiscal governance.

41. **As a first step in trying to identify the various forces that shaped fiscal policymaking before and after the fiscal framework, a fiscal reaction function is estimated**. The dependent variable in this analysis is the cyclically-adjusted primary balance, which reflects discretionary fiscal policy. Many empirical studies have estimated fiscal policy reaction functions but this paper follows in the footsteps of those—such as Gali and

Perotti (2003), Balassone and Franco (2004), and Debrun and Faruqee (2004)—that sought to determine whether fiscal policymaking had changed following the advent of the fiscal framework. In particular, the baseline model will follow that of these works, focusing on a number of key economic influences on discretionary fiscal policy—including the economic cycle, lagged debt, and a persistence factor—supplemented by the relevant political factors.

42. **The following equation is fitted to the data**:

$$BAL_{i,t} = \alpha_i + \beta_1 BAL_{i,t-1} + \beta_2 DEBT_{i,t-1} + \beta_3 GAP_{i,t} + \beta_4 ELEC_{i,t} + \beta_5 COM_{i,t} + \beta_6 DEL_{i,t} + \beta_7 SIZE_{i,t} + \beta_8 VOL_{i,t} + \varepsilon_{i,t}$$

where i denotes a country, t is a time subscript, and BAL denotes the cyclically-adjusted primary balance. The α_i component denotes a country fixed effect. The regressors include a lagged dependent variable, the gross public debt ratio (DEBT); the output gap (GAP); a dummy for an election year (ELEC); a dummy for commitment or mixed forms of fiscal governance (COM)[11]; a dummy for delegation (DEL); relative economic size defined as the ratio of real GDP to the real GDP of the EU15, or to the real GDP of the EU12, depending on the sample (SIZE); and economic volatility defined as the standard deviation of real economic growth spanning the past 10 years (VOL). The baseline economic determinants of fiscal policy are common to the literature and are expected to be important over the whole time period. Likewise, many have pointed to the importance of elections in influencing fiscal policy. But some of the other variables—including the fiscal governance dummies, relative economic size, and economic volatility—may be more relevant after the introduction of the fiscal framework, especially the SGP.

43. **A panel model is estimated using both fixed effects and pooled OLS.** The sample consists of annual data from 1980-2004, for all EU members except Luxembourg. Separate panel regressions are estimated for the EU11. To be consistent with other studies in the area (especially Debrun and Faruqee, 2004), the data are all derived from the OECD. To account for the possible endogeneity between fiscal policy and the output gap, all equations are estimated with two-stage least squares, using lagged output gaps as instruments. The use of fixed effects in a dynamic panel equation can be criticized, given the noted bias. But Judson and Owen (1999) argue that when the time series is long enough relative to the cross-section dimension, the bias inherent in dynamic panel estimation is not large enough to make alternative estimators more desirable. Indeed, they find that the LSDV estimator performs better than alternatives with 30 or more years of data. Others have argued that when the time

[11] For the purposes of the analysis in this section, "mixed" systems are placed under the commitment banner, given that these states also employ fiscal contracts and numerical targets, and show should be compatible with the kinds of fiscal rules under Maastricht and the SGP. For the remainder of this paper, the term "commitment" also encompasses "mixed" systems.

span covered by the data is reasonably large (around 22), then the application of IV-type estimators to a first differenced version of the dynamic panel model does not seem necessary, and can even lead to a large loss of efficiency (see Haque, Pesaran, and Sharma, 1999). Gali and Perotti (2003) justify the inclusion of the lagged dependent variable by arguing that their main interest is not in the coefficient itself, but how it changes between two periods. Others, however, favor pooled OLS on the grounds that many variable exhibit more between than within-country variation; institutional variables in particular tend not to vary much over time (Hallerberg, Strauch, and von Hagen, 2004).

44. **The empirical strategy takes three different tacks.** First, a simple model is estimated for the entire period, with no allowance for differing coefficients between sub-periods. Second, the model is estimated permitting the coefficients for the key variables under consideration—form of fiscal governance, growth volatility, and relative economic size—to differ before and after the SGP (or Maastricht). Third, the model is estimated so that every coefficient can vary between periods.

45. **The baseline results are similar to those of previous studies.** Table 4 provides detailed equations for the period as a whole, both for the EU14 and EU11, with and without country dummies. The persistence parameter is highly significant, with a magnitude similar to that of Debrun and Faruqee (2004). Especially for the euro area, the coefficient on the output gap is negative and significant, suggesting a pattern of procyclicality across countries. Again, this is consistent with past evidence. But evidence of a procyclical fiscal reaction is much weaker for the EU as a whole. Lagged debt is also an important determinant of the fiscal position, as policymakers react to high public debt stocks by running a tighter policy, in line with longer-term sustainability requirements. Again, the magnitude of this coefficient, which differs little across the various specifications, is similar to that estimated by Debrun and Faruqee (2004). The coefficient on the election year dummy is negative and highly significant in all specifications, suggesting that the prevalence of elections does indeed lead to fiscal policy loosening—the magnitude is about 0.66 in the euro area, and only slightly lower in the EU as a whole. This is in line with past studies which noted the strong electoral motive for fiscal policy in the EU (Tujula and Wolswijk, 2004).

46. **All equations are estimated with the commitment and delegation dummies, but only some include the volatility and size variables as well.** This is to make explicit allowance for any multicollinearity problems that may arise from the close relationship between small open economies and the tendency to adopt commitment technology. As expected, there is little evidence that the three factors thought to influence fiscal policy reaction functions under the EU fiscal framework—fiscal governance, volatility, and size—affect the cyclically-adjusted primary balance for the period as a whole, with the single exception of the commitment dummy. There is evidence that commitment contributed to superior fiscal performance across the sample, while delegation did not. This is at odds with the claim that both commitment and delegation can be used to internalize the externality associated with common pool problem in fiscal policy (see Hallerberg, 2004).

Table 4: Fiscal Policy Determination in the European Union, 1980-2004

(Dependent variable: cyclically-adjusted primary balance 1/)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	EU-14	EU-14	EU-14	EU-14	EU-11	EU-11	EU-11	EU-11
Lagged CAPB	0.75***	0.70 ***	0.75***	0.71 ***	0.75***	0.70 ***	0.75***	0.70 ***
	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)	(0.05)	(0.04)	(0.05)
Output gap	-0.07**	-0.03	-0.06*	-0.02	-0.10***	-0.07**	-0.10**	-0.07*
	(0.03)	(0.03)	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)
Lagged debt	0.01***	0.03***	0.01***	0.03***	0.01***	0.02***	0.01***	0.02***
	(0.003)	(0.01)	(0.003)	(0.01)	(0.003)	(0.01)	(0.003)	(0.01)
Commitment	0.67***	0.52*	0.69***	0.52*	0.62***	0.55**	0.64***	0.55**
	(0.23)	(0.28)	(0.23)	(0.28)	(0.22)	(0.27)	(0.22)	(0.27)
Delegation	0.25	0.12	0.33	0.16	0.26	0.29	0.33	0.30
	(0.20)	(0.40)	(0.28)	(0.40)	(0.20)	(0.40)	(0.28)	(0.41)
Growth volatility			0.09	0.09			0.05	0.03
			(0.08)	(0.12)			(0.08)	(0.13)
Relative economic size			-0.002	-0.02			-0.002	-0.05
			(0.01)	(0.15)			(0.01)	(0.13)
Election year	-0.63***	-0.62***	-0.63***	-0.61***	-0.67***	-0.66***	-0.66***	-0.65***
	(0.17)	(0.17)	(0.17)	(0.17)	(0.18)	(0.18)	(0.18)	(0.18)
R^2	0.78	0.79	0.78	0.79	0.80	0.81	0.80	0.81
N	346	346	346	346	272	272	272	272
Country dummies?	No	Yes	No	Yes	No	Yes	No	Yes

1/ Robust standard errors in parentheses; 2SLS estimation.
***= t-statistic significant at 1 percent level; **= t-statistic significant at 5 percent level; *= t-statistic significant at 10 percent level.

47. **The second set of equations detail the results of allowing the key coefficients to vary between periods—before and after the inauguration of the fiscal framework.** Table 5 provides the results allowing for different coefficients for core variables before and after the introduction of the SGP. As before, equations are estimated both for the EU14 and EU11, with and without country fixed effects. And again, while all of the equations include commitment and delegation dummies, only some provide all of the major variables under consideration in tandem. The coefficients and standard errors associated with the control variables are broadly unchanged. But a different picture emerges when looking at the time-varying coefficients.

Table 5: Fiscal Policy Behavior in the European Union Before and After SGP I

(Dependent variable: cyclically-adjusted primary balance 1/)

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
		EU-14	EU-14	EU-14	EU-14	EU-11	EU-11	EU-11	EU-11
Lagged CAPB		0.75***	0.69***	0.74***	0.69***	0.75***	0.67***	0.73***	0.67***
		(0.04)	(0.04)	(0.04)	(0.04)	(0.04)	(0.05)	(0.04)	(0.05)
Output gap		-0.06*	-0.02	-0.06*	-0.02	-0.10**	-0.07**	-0.11**	-0.08*
		(0.04)	(0.03)	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)
Lagged debt		0.02***	0.03***	0.02***	0.03***	0.02***	0.03***	0.02***	0.03***
		(0.003)	(0.01)	(0.003)	(0.01)	(0.003)	(0.01)	(0.003)	(0.01)
Commitment	Pre-SGP	0.63***	0.37	0.67***	0.38	0.57**	0.42	0.61***	0.45
		(0.24)	(0.29)	(0.24)	(0.29)	(0.23)	(0.29)	(0.23)	(0.29)
	Post-SGP	0.72**	0.78**	0.34	0.59	0.81***	1.01***	0.33	0.69*
		(0.28)	(0.34)	(0.32)	(0.42)	(0.31)	(0.36)	(0.31)	(0.42)
Delegation	Pre-SGP	0.50**	0.75*	0.83**	0.80	0.54**	1.04**	1.01**	1.19**
		(0.22)	(0.42)	(0.36)	(0.52)	(0.22)	(0.43)	(0.41)	(0.54)
	Post-SGP	-0.13	-0.10	-0.35	-0.20	-0.06	0.09	-0.35	-0.15
		(0.23)	(0.40)	(0.41)	(0.49)	(0.23)	(0.40)	(0.41)	(0.49)
Election year		-0.64***	-0.63***	-0.64***	-0.63***	-0.68***	-0.69***	-0.68***	-0.69***
		(0.16)	(0.16)	(0.17)	(0.17)	(0.18)	(0.18)	(0.18)	(0.18)
Growth volatility	Pre-SGP			0.02	0.04			-0.01	-0.01
				(0.09)	(0.12)			(0.09)	(0.13)
	Post-SGP			0.23	0.14			0.24	0.15
				(0.15)	(0.16)			(0.15)	(0.17)
Relative economic size	Pre-SGP			-0.02	0.001			-0.02	-0.07
				(0.02)	(0.15)			(0.02)	(0.13)
	Post-SGP			-0.01	0.002			-0.01	-0.06
				(0.02)	(0.16)			(0.02)	(0.13)
R^2		346	346	346	346	272	272	272	272
N		0.79	0.80	0.79	0.80	0.81	0.82	0.81	0.82
Country dummies		No	Yes	No	Yes	No	Yes	No	Yes

1/ Robust standard errors in parentheses; 2SLS estimation.
***= t-statistic significant at 1 percent level; **= t-statistic significant at 5 percent level; *= t-statistic significant at 10 percent level.

- *First*, in most specifications, the post-SGP commitment coefficient is positive and significant, and larger than the pre-SGP coefficient, suggesting that countries operating with commitment-style budgetary institutions were more inclined toward fiscal discipline in the EMU period.[12] But, at least in the variants of the model without country dummies, the coefficients on commitment prior to the SGP are also positive and significant.

- *Second*, there is evidence that the delegation form of fiscal governance control contributed positively to fiscal discipline prior to the SGP, but not afterwards. This effect is larger in the euro area.

- *Third*, there is no evidence that either volatility or relative economic size had an impact on fiscal policy after the SGP.

This analysis is repeated in its entirety for the pre and post-Maastricht era in Table 6. Here, there is less evidence that commitment was an effective strategy before Maastricht, especially in the euro area.[13] But again, delegation was more effective in the pre-Maastricht era, while the fiscal framework proved more compatible with commitment. And there is still no evidence of a role for volatility or size.

[12] Multicollinearity may come into play in the variants of the model that include post-SGP volatility and size, given that the magnitude of the post-SGP commitment coefficient drops significantly when these other variables are included, and is no longer statistically significant.

[13] Though the small number of commitment countries prior to 1992 could play a role here.

Table 6: Fiscal Policy Behavior in the European Union Before and After Maastricht I

(Dependent variable: cyclically-adjusted primary balance 1/)

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
		EU-14	EU-14	EU-14	EU-14	EU-11	EU-11	EU-11	EU-11
Lagged CAPB		0.75*** (0.04)	0.69*** (0.04)	0.73*** (0.04)	0.69*** (0.04)	0.75*** (0.04)	0.69*** (0.05)	0.71*** (0.04)	0.67*** (0.05)
Output gap		-0.06* (0.04)	-0.02 (0.04)	-0.05 (0.04)	-0.02 (0.04)	-0.10*** (0.04)	-0.06* (0.04)	-0.10** (0.04)	-0.08** (0.04)
Lagged debt		0.01*** (0.003)	0.03*** (0.01)	0.02*** (0.003)	0.03*** (0.01)	0.01*** (0.003)	0.03*** (0.01)	0.01*** (0.003)	0.02*** (0.01)
Commitment	Pre-Maastricht	0.62* (0.33)	0.30 (0.36)	0.72** (0.32)	0.34 (0.35)	0.51 (0.33)	0.29 (0.37)	0.67** (0.32)	0.44 (0.36)
	Post-Maastricht	0.71*** (0.22)	0.60** (0.28)	0.45 (0.33)	0.52 (0.39)	0.68*** (0.22)	0.64** (0.28)	0.27 (0.29)	0.30 (0.35)
Delegation	Pre-Maastricht	0.57** (0.24)	0.77* (0.44)	1.34** (0.45)	1.42** (0.67)	0.54** (0.25)	0.93** (0.44)	1.74*** (0.60)	2.41*** (0.72)
	Post-Maastricht	0.10 (0.21)	0.10 (0.26)	-0.17 (0.37)	0.03 (0.44)	0.14 (0.21)	0.25 (0.41)	-0.26 (0.34)	-0.02 (0.43)
Election year		-0.63*** (0.17)	-0.62*** (0.17)	-0.63*** (0.17)	-0.62*** (0.17)	-0.67*** (0.18)	-0.67*** (0.18)	-0.69*** (0.18)	-0.68*** (0.18)
Growth volatility	Pre-Maastricht			0.002 (0.13)	0.08 (0.14)			-0.08 (0.12)	-0.02 (0.14)
	Post-Maastricht			0.13 (0.09)	0.09 (0.14)			0.14 (0.10)	0.13 (0.16)
Relative economic size	Pre-Maastricht			-0.04 (0.03)	0.01 (0.16)			-0.04* (0.02)	-0.09 (0.13)
	Post-Maastricht			0.001 (0.02)	0.05 (0.16)			-0.001 (0.02)	-0.03 (0.13)
R^2		346	346	346	346	272	272	272	272
N		0.79	0.80	0.79	0.80	0.81	0.82	0.81	0.82
Country dummies?		No	Yes	No	Yes	No	Yes	No	Yes

1/ Robust standard errors in parentheses; 2SLS estimation.
***= t-statistic significant at 1 percent level; **= t-statistic significant at 5 percent level; *= t-statistic significant at 10 percent level.

48. **The third approach involves estimating an equation in which the coefficients of all variables are allowed to differ between the two periods.** In this setup, only the full model with all variables included is reported. Table 7 provides results pertaining to the SGP. The main results are as follows:

- The procyclicality of fiscal policy is very much a post-SGP phenomenon; the coefficient (-0.20) is far larger than its pre-SGP counterpart. This is consistent with the "disturbing post-EMU trends" identified by Debrun and Faruqee (2004), which they claim is due to a heightened tendency to loosen during good times.

- A further interesting result is that the deficit bias being generated by elections exists in both the pre- and post-SGP periods, though its magnitude declines in the latter period. While this is consistent with the findings of Buti and van den Noord (2004) pointing to the prevalence of electoral cycles to explain the deficit bias under EMU (the coefficient is also larger for the EU11 than for the EU14), the effect is still lower than before.

- In terms of the fiscal governance variables, the results that commitment is beneficial post-SGP, and delegation is more favorable in the pre-SGP era, still holds, but only in the pooled OLS variant of the model.[14]

- High growth volatility leads to more fiscal discipline under the SGP, but not beforehand. This is consistent with the "external anchor" hypothesis.

- There is evidence that size matters, in the sense that larger countries adopted looser fiscal policies after the SGP (but not beforehand)—this holds only in the version of the model incorporating fixed effects. The result is not robust to changing to the definition of relative economic size from real GDP to population, or to using a measure of absolute economic size.

49. **This analysis is repeated in Table 8, which instead takes the Maastricht treaty as the break point.** Here, many of the results are similar to Gali and Perotti (2003) and Debrun and Faruqee (2004), who also split the sample at precisely this point. In particular, the Gali-Perotti result on the cyclical of discretionary fiscal policy—that it was procyclical prior to Maastricht and essentially acyclical thereafter—is confirmed for the euro area (whether or not country dummies are included). This is a markedly different result from Table 7, and suggests that the benefits of the fiscal rule in terms of making fiscal policy less procyclical evaporated after the onset of EMU. The other results are broadly similar, except that the commitment technology seems less effective after Maastricht than under the SGP. Also, while there is some evidence that higher growth volatility is associated with better fiscal discipline under Maastricht, this only holds in the fixed effects version of the model, and even here the coefficient is far lower than the corresponding post-SGP coefficient in Table 7. While still evident, the electorally-induced distortion is lower in the post-Maastricht era; as these coefficients are smaller than the corresponding post-SGP coefficients in Table 7, there

[14] Given that the fiscal governance variables exhibit little, if any, time variation, fixed effects estimation may be unreliable.

Table 7: Fiscal Policy Behavior in Europe Before and After SGP II

(Dependent variable: cyclically-adjusted primary balance 1/)

		(1)	(2)	(3)	(4)
		EU-14	EU-14	EU-11	EU-11
Lagged CAPB	Pre-SGP	0.75***	0.68***	0.74***	0.66***
		(0.04)	(0.05)	(0.04)	(0.05)
	Post-SGP	0.70***	0.50***	0.68***	0.52***
		(0.06)	(0.10)	(0.07)	(0.12)
Output gap	Pre-SGP	-0.04	0.001	-0.09**	-0.06
		(0.04)	(0.04)	(0.04)	(0.05)
	Post-SGP	-0.20	-0.19**	-0.22*	-0.20**
		(0.13)	(0.09)	(0.13)	(0.10)
Lagged debt	Pre-SGP	0.02***	0.04***	0.02***	0.03***
		(0.003)	(0.01)	(0.003)	(0.01)
	Post-SGP	0.01**	0.05*	0.01**	0.04
		(0.005)	(0.03)	(0.005)	(0.03)
Commitment	Pre-SGP	0.63**	0.40	0.57**	0.41
		(0.25)	(0.33)	(0.24)	(0.34)
	Post-SGP	0.72**	-0.95	0.74**	-0.87
		(0.35)	(0.64)	(0.35)	(0.67)
Delegation	Pre-SGP	0.84**	0.59	0.99**	0.77
		(0.36)	(0.72)	(0.41)	(0.73)
	Post-SGP	0.16	0.27	0.14	0.36
		(0.45)	(0.54)	(0.47)	(0.54)
Relative economic size	Pre-SGP	-0.02	0.003	-0.02	-0.03
		(0.02)	(0.20)	(0.02)	(0.16)
	Post-SGP	-0.02	-1.91***	-0.02	-1.49**
		(0.02)	(0.62)	(0.02)	(0.73)
Growth volatility	Pre-SGP	0.03	-0.03	-0.004	-0.12
		(0.09)	(0.17)	(0.09)	(0.17)
	Post-SGP	0.32**	0.76***	0.31**	0.69***
		(0.15)	(0.19)	(0.16)	(0.21)
Election year	Pre-SGP	-0.67***	-0.64***	-0.73***	-0.72***
		(0.20)	(0.21)	(0.23)	(0.23)
	Post-SGP	-0.49**	-0.45**	-0.51**	-0.47**
		(0.24)	(0.20)	(0.23)	(0.21)
R^2		346	346	272	272
N		0.79	0.81	0.81	0.83
Country dummies?		No	Yes	No	Yes

1/ Robust standard errors in parentheses; 2SLS estimation.
***= t-statistic significant at 1 percent level; **= t-statistic significant at 5 percent level; *= t-statistic significant at 10 percent level.

Table 8: Fiscal Policy Behavior in Europe Before and After Maastricht II

(Dependent variable: cyclically-adjusted primary balance 1/)

		(1)	(2)	(3)	(4)
		EU-14	EU-14	EU-11	EU-11
Lagged CAPB	Pre- Maastricht	0.74***	0.62***	0.72***	0.56***
		(0.05)	(0.06)	(0.05)	(0.07)
	Post- Maastricht	0.71***	0.62***	0.68***	0.57***
		(0.05)	(0.07)	(0.06)	(0.08)
Output gap	Pre- Maastricht	-0.07	-0.05	-0.12**	-0.13***
		(0.05)	(0.05)	(0.05)	(-0.05)
	Post- Maastricht	-0.03	0.05	-0.09	-0.04
		(0.06)	(0.07)	(0.05)	(0.07)
Lagged debt	Pre- Maastricht	0.02***	0.06***	0.01***	0.06***
		(0.004)	(0.01)	(0.004)	(0.02)
	Post- Maastricht	0.02***	0.04***	0.02***	0.03***
		(0.004)	(0.01)	(0.005)	(0.01)
Commitment	Pre- Maastricht	0.73**	-0.33	0.75**	-0.16
		(0.35)	(0.57)	(0.33)	(0.64)
	Post- Maastricht	0.46	0.69	0.28	-0.11
		(0.35)	(0.66)	(0.30)	(0.53)
Delegation	Pre- Maastricht	1.25**	...	1.62**	...
		(0.50)		(0.66)	
	Post- Maastricht	-0.16	-0.04	-0.25	-0.09
		(0.39)	(0.50)	(0.36)	(0.48)
Relative economic size	Pre- Maastricht	-0.03	-0.50*	-0.04	-0.50*
		(0.03)	(0.30)	(0.03)	(0.28)
	Post- Maastricht	-0.001	0.40	-0.004	0.27
		(0.02)	(0.33)	(0.01)	(0.32)
Growth volatility	Pre- Maastricht	0.05	0.29	0.01	0.32
		(0.14)	(0.26)	(0.13)	(0.31)
	Post- Maastricht	0.14	0.32**	0.15	0.31*
		(0.10)	(0.16)	(0.11)	(0.17)
Election year	Pre- Maastricht	-0.89***	-0.96***	-0.98***	-1.03***
		(0.26)	(0.26)	(0.30)	(0.30)
	Post- Maastricht	-0.38**	-0.32	-0.40**	-0.37*
		(0.19)	(0.21)	(0.18)	(0.19)
R^2		346	346	272	272
N		0.79	0.82	0.82	0.84
Country dummies?		No	Yes	No	Yes

1/ Robust standard errors in parentheses; 2SLS estimation.
***= t-statistic significant at 1 percent level; **= t-statistic significant at 5 percent level; *= t-statistic significant at 10 percent level.

is some support for the theory that political budget cycles played a role in hindering the effectiveness of the SGP (Buti and van den Noord, 2004). Finally, there is no evidence that fiscal policy was worse in larger countries in the post-Maastricht era; this seems to have been a uniquely SGP phenomenon. Curiously, there is some evidence that larger countries were more undisciplined prior to Maastricht.

50. **Further empirical evidence can be mustered from the forecasts contained in successive Stability Programs.** It has already been noted that many countries tended to rely on overly-optimistic assumptions to postpone adjustment under the SGP. Previous studies have addressed the role of fiscal governance in this context. Hallerberg, Strauch, and von Hagen (2001), for example, note that Stability Programs are more integrated into the national budget processes in commitment countries. One possible reason is that commitment states are more inclined to opt for more conservative forecasts, as parties build in significant safety margins to reduce the likelihood of renegotiation (Strauch, Hallerberg, and von Hagen, 2004). These authors also highlight an empirical relationship between commitment (and mixed) states and cautious forecasts, controlling for economic factors.

51. **Was the tendency toward cautious forecasting related more broadly to the factors that make the SGP more suitable to some countries than others?** Table 9 reports the results of a regression where the dependent variable is the one and two-year forecast errors of the overall fiscal balance for the EU12 under the SGP (1999-04).[15] The following equation is fitted to the data for the forecast error (FE):

$$FE_{i,t} = \alpha_i + \partial_1 GAP_{i,t} + \partial_2 GOODTIMES_{i,t} + \partial_3 COM_{i,t} + \partial_4 DEL_{i,t} + \partial_5 SIZE_{i,t} + \partial_6 VOL_{i,t} + +\varepsilon_{i,t}$$

The output gap captures the economic background during budgetary planning. This variable is supplemented with a dummy for the specific "good times" during 1999-00, a unique period when the scale of the IT-related boom was far beyond the expectations of most forecasters. Regressors also include the factors deemed to influence fiscal policy in the post-EMU period—fiscal governance, relative economic size, and volatility. As before, both pooled OLS and fixed effects versions of the model are estimated. The coefficient on the output gap is negative and significant, at least for one-year-ahead forecasts. This is consistent with previous research (Strauch, Hallerberg, and Von Hagen, 2004) and can be interpreted as a tendency towards optimistic forecasting in good times and more cautious forecasting during bad times.[16] Also, the coefficient on the good times dummy is positive and significant, as expected. In terms of fiscal governance, commitment countries have a tendency toward more positive, or less negative, forecast errors, which supports the argument that these countries

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[15] The forecast error is defined simply as the fiscal balance minus the projected fiscal balance.

[16] This result holds when the lag of the output gap is used.

are less prone to overly-optimistic assumptions under the SGP.[17] There is also some evidence of more conservative forecasting among countries with high growth volatility, but only for the 2-year ahead forecasts in the pooled OLS variant; this is again consistent with past research.[18] Economic size matters little.

Table 9: Forecast Errors Under Stability Programs, 1999-04

(Dependent variable: forecast error of overall balance 1/)

	(1)	(3)	(2)	(5)
Forecasting period	1-year ahead	1-year ahead	2-year ahead	2-year ahead
	EU-11	EU-11	EU-11	EU-11
Output gap	-0.19*	-0.25**	-0.08	-0.05
	(0.11)	(0.10)	(0.19)	(0.14)
Good times (1999-00)	1.61***	2.13***	2.28***	2.65***
	(0.40)	(0.40)	(0.81)	(0.66)
Commitment	1.35***	0.42	2.07***	-1.91
	(0.42)	(1.55)	(0.61)	(1.72)
Delegation	-0.16	1.54	0.70	...
	(0.64)	(1.20)	(0.98)	
Growth volatility	0.07	-0.22	0.60*	0.52
	(0.21)	(0.25)	(0.32)	(0.38)
Relative economic size	0.04	1.33	0.02	2.09
	(0.03)	(1.08)	(0.04)	(1.70)
R^2	0.37	0.59	0.42	0.62
N	65	65	54	54
Estimation method	Pooled OLS	Fixed effects	Pooled OLS	Fixed effects

1/ Defined as fiscal balance minus projected fiscal balance from Stability Programs.
***= t-statistic significant at 1 percent level; **= t-statistic significant at 5 percent level; *= t-statistic significant at 10 percent level.

[17] This result is evident only in the pooled OLS versions of the model.

[18] Output volatility could result in more cautious forecasts if policymakers are risk-averse (Strauch, Hallerberg, and von Hagen 2004). This is compatible with the external anchor hypothesis.

52. **The role of fiscal governance in forecasting is bolstered by examining the prevalence of positive forecast errors among countries.** As can be seen from Figure 6, the frequency of positive surprises (a higher balance or a lower deficit than expected) is far higher among commitment countries. This is particularly pronounced during the downturn years, when positive surprises were rare to non-existent among delegation countries, while they were a fairly common occurrence among commitment countries. Again, this lends support to the hypothesis that commitment countries are more likely to adopt cautious forecasts.

53. **In sum, when considering the different fiscal behavior before and after the introduction of the fiscal framework in Europe, the following conclusions are suggested**:

- *Commitment countries* performed better under the SGP, but delegation countries experienced greater fiscal discipline in the pre-SGP (and indeed the pre-Maastricht) era. Commitment countries also had a tendency to take Stability Programs more seriously, in the sense of having lower forecast errors in their budgetary projections. The fiscal framework may be more compatible with the commitment technology, than delegation which relies more on domestic institutions.

- Countries experiencing *high growth volatility* tend to adopt more disciplined fiscal policy under the fiscal framework, and especially under the SGP.

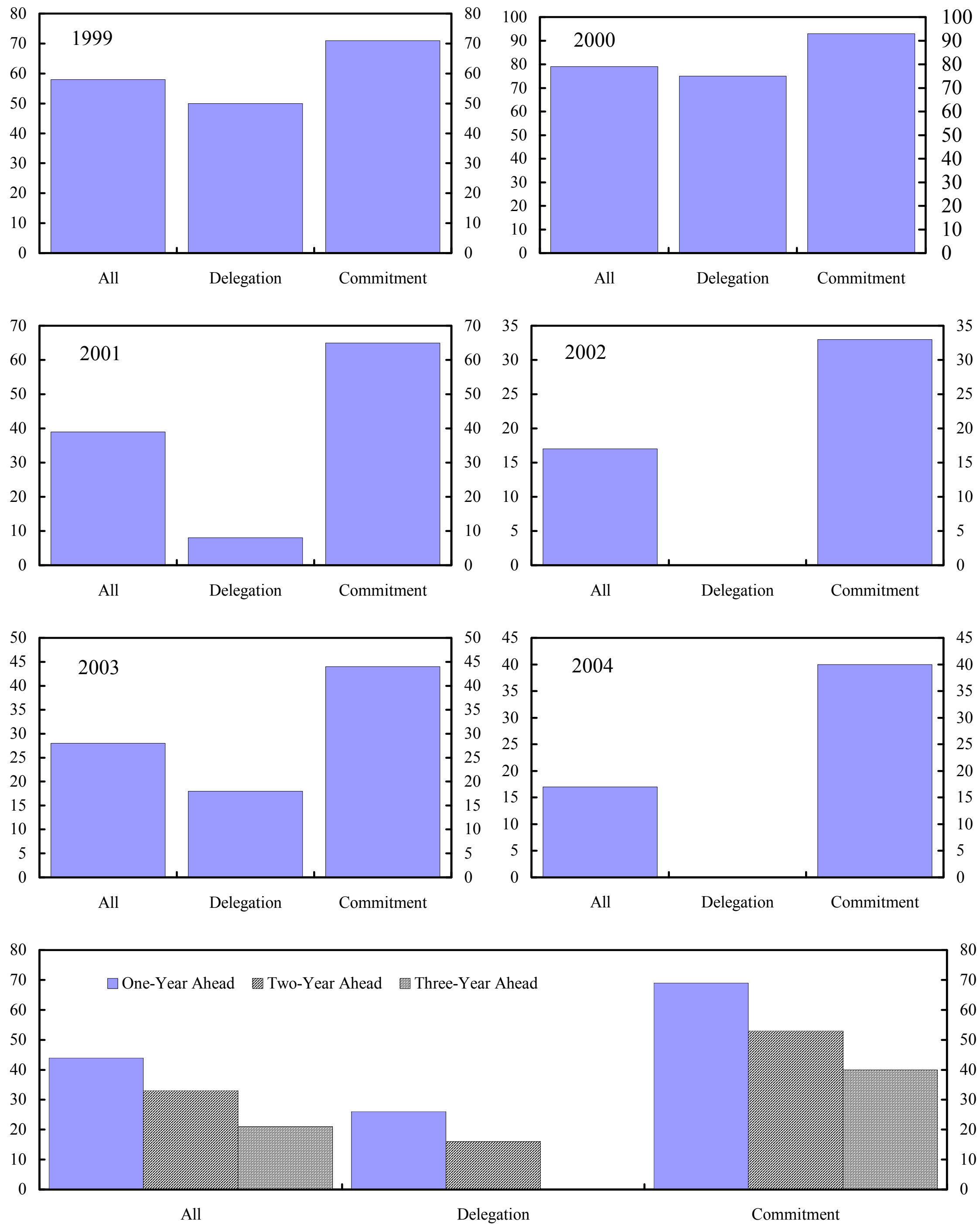
- *Larger countries*, defined in terms of economic size, performed worse under the SGP than smaller counties, but not beforehand. This is compatible with the political economy approach which stresses that ownership has shifted from the large to the small countries, as the Maastricht treaty morphed into the SGP.

- *Electorally-motivated* fiscal profligacy is evident in every period, though it may have fallen under Maastricht, and risen again under the SGP.

- A *procyclical* fiscal history (especially in the euro area) was eliminated after the advent of Maastricht, but returned during the SGP era.

Note that the three key variables of interest—fiscal governance, volatility, and relative size—do not always possess significant coefficients in the same specification of the equation, possibly reflecting multicollinearity. Hence the conclusions above should be interpreted with some caution.

Figure 6. Percentage of Positive Forecast Errors for Overall Balance, 1999-2004



Source: Stability Programs and IMF staff estimates.

VI. Assessment and Proposals

54. **Despite recent criticism, the record on preventive arm enforcement to date has been reasonably positive, especially for a clear sub-group of member states.** As seen from the empirical evidence, success under the SGP is associated with certain characteristics, such as smallness, volatility, and reliance on the commitment form of fiscal governance. And indeed, it contributed to fiscal discipline in countries like Austria, Belgium, Finland, Ireland, Netherlands, and Spain (as well as Denmark and Sweden from outside the euro area). These countries had pretty much all attained CBS by 2004. Given the conventional wisdom that CBS is the minimum standard needed for countries to move to the new demographic steady state while keeping debt on a sustainable path, the SGP will retain its importance into the future. Clearly then, the preventive arm, which deals with optimal policy, is crucial. Moreover, had the other countries adjusted earlier in the direction of CBS, they would likely have avoided getting enmeshed in the protracted EDP. The issue then, is how the Pact should be re-modeled to make it more acceptable to the non-complying countries, while not harming its disciplining effect in others. The recent SGP reform should be seen through this prism.

55. **The importance of the SGP will only increase as the EU expands.** Many of the new and acceding members have fiscal problems, and have run higher deficits than the norm in the EU over the past few years (Table 10). A fiscal framework such as the SGP should be suited to their needs, given that they tend to possess the characteristics most favorable to its success. First, most of them have adopted some form of commitment technology. As documented by Ylaoutinen (2004), nearly all central and eastern European countries use some kind of proportional representation in their electoral processes, and rely predominantly on commitment; only Hungary and Slovenia have adopted delegation (see Table 10). Indeed, most of the commitment countries have strengthened their institutions in recent times, mainly by establishing multi-annual frameworks, possibly in anticipation of the SGP. Second, the economic size of these countries is far below the EU average, suggesting that they might be more amenable to external influences over fiscal policy. Third, these countries also tend to be among the more volatile countries in Europe in terms of economic growth; the standard deviation of growth over the past 10 years of the new and acceding members was twice that of the older EU members (Table 10). The importance of an external fiscal anchor is only going to increase over the next few years.

56. **The SGP reform process has been guided by the desire to bolster legitimacy through taking greater account of country-specific factors.** This kind of thinking heralded the recent SGP reform, which was designed to take account of more country-specific sustainability considerations in the preventive arm and to tailor the EDP to economic circumstances. Drawing this reasoning to its logical conclusion, the increasing economic diversification in a growing union would appear to justify the additional flexibility, especially in setting the medium-term objective (Flores, Guidice, and Turrini, 2005). Better economic underpinnings could indeed make the Pact more legitimate, and hence more enforceable. Indeed, legitimacy is a crucial, if often overlooked, component of economic policy coordination in EMU (Hodson and Maher, 2002), and has been elevated by some

alongside credibility and flexibility as among the most important facets of a fiscal framework (UK Treasury, 2004).

Table 10. New and Acceding EU Members: Some Stylized Facts

	Average fiscal balance 1/	Fiscal Governance	Relative economic size 2/	Economic volatility 3/
Bulgaria	0.5	Commitment (from 1998)	0.13	5.4
Czech Republic	-6.2	Commitment (from 1994)	0.59	2.1
Cyprus	-3.9	...	0.11	1.4
Estonia	1.2	Commitment (from 1994; strengthened 2001)	0.05	3.0
Hungary	-5.2	Delegation (from 2002)	0.55	1.2
Latvia	-2.0	Commitment (from 1994; strengthened 2001)	0.07	2.0
Lithuania	-2.1	Commitment (from 1999; strengthened 2000)	0.09	3.2
Malta	-6.8	...	0.04	3.1
Poland	-3.5	Commitment (from 1999)	1.72	1.9
Romania	-2.5	Commitment (from 1994; strengthened 2003)	0.35	4.9
Slovakia	-6.2	Commitment (from 1994; strengthened 2000)	0.24	1.5
Slovenia	-2.5	Delegation (from 1994)	0.25	1.0
Average	-3.3	...	0.35	2.6
Average EU-14	-0.6	...	6.93	1.3
Average EU-11	-1.1	...	7.18	1.3
Average EU-8 4/	-0.5	...	2.88	1.5

Source: Ylaotinen (2004); Eurostat.

1/ General government net lending, average 2000-2004.
2/ Real GDP as a percent of EU25 total, average 2000-2004.
3/ Standard deviation of real growth rate, average 1996-2004.
4/ EU-11 excluding France, Germany, and Italy.

57. **If flexibility is taken too far, however, the external anchor function of the SGP would be harmed.** Given that the framework worked well for a core group of countries and is likely to work equally well for the newer members, watering it down too much could prove detrimental to fiscal discipline. If taken too far, proposals that increase flexibility would tilt the framework in the direction of the countries that did not fare so well under the SGP—the larger or delegation countries, countries that are more inclined to respond to domestic considerations. Indeed, in the extreme case, some have argued that counties should have complete freedom to enact any fiscal rule they chose, as long as it is compatible with sustainability (Wren-Lewis, 2003). This could threaten the external anchor. Berger, Kopits, and Szekely (2004) argue that laxity in enforcing the SGP against the large countries could have a negative demonstration effect on the newer members; with the lower likelihood of being sanctioned, fiscal policy could become less disciplined. At the same time, proposals to vest even more enforcement powers with external bodies, such as the European Court of Justice (Calmfors and Corsetti, 2003) to bolster enforcement are unrealistic. If the larger and delegation countries take little heed of the current SGP, they are unlikely to embrace more rigid enforcement.

58. **Ultimately, successful supranational fiscal policy coordination needs to rely on soft law** (see Box 1 for an overview of the issues). The Pact has always existed in the soft law sphere, and the recent reforms, which create more flexibility and leeway for countries, tilt it further in this direction. The inherent uncertainty surrounding fiscal policy evaluation is conducive to a soft law environment. The unknown nature of future economic shocks calls for an element of flexibility in assessing fiscal policy. In the context of the SGP, even assessing the medium-term underlying balance is riddled with uncertainty. Hodson (2004) goes further and points to diagnostic uncertainty about the exact nature of the fiscal policy spillover, and prescriptive uncertainty over whether such coordination is even the right response to a fiscal spillover. Such flexibility can also take account of "divergent national circumstances". Others have argued that a decentralized approach is best when preferences are heterogeneous, as they tend to be for fiscal policy (Alesina and Wacziarg, 1999).

59. **To be effective, however, softer forms of fiscal policy coordination need mechanisms to facilitate enforceability.** A number of observers try to pin-point the conditions under which soft law can be effective. Padoan (2002) identifies two different kinds of incentives most relevant in the European context: a competition incentive and a cooperation incentive. Under the former, a non-complying state would see its reputation diminish both in the market and in the policy arena (in particular, influencing the design of EU policies). The cooperation incentive operates under the presumption that harmful behavior in one country affects other countries, making peer pressure an effective disciplining device. Another, similar, approach stresses the need to build consensus and to make peer pressure effective (Hodson, 2004). Yet another observer argues that credible rules require either self-enforcement or a strong external agent, and that self-enforcement only works if the rule makes sense to the country, or if it has a "totemic" or "sacral" quality (Buiter, 2002).

60. **Looking back, many observers were skeptical about the potential for soft law enforcement under the SGP.** Amtenbrink and de Haan (2003) argue that neither the competition nor the cooperation incentives really bound in the context of the SGP. They downplay the importance of spillovers, and argue that financial markets have not disciplined countries in contravention of the SGP. Moreover, they maintain that countries are loath to judge their peers for fear that they themselves could be in a similar situation on some future date. Hodson and Maher (2004) reach similar conclusions, arguing that for peer pressure to bind, the obligation must be defined precisely, the sanctioner must be credible and willing to reprimand, and states must see the rebuke as costly; in the context of the SGP, all are in doubt. Moreover, Buiter (2002) argues that since the SGP is not tailored to individual country circumstances, and has not attained "sacral" status, self-enforcement will not work.

Box 1: Hard and Soft Law in the European Union

The distinction between "hard" and "soft" law helps in analyzing community-wide economic governance and policy coordination issues. Conceptually, "hard law" comprises legally binding obligations that are precise and delegate authority for interpreting and implementing the law (Abbot and Snidal, 2000). There are three distinct concepts here. First, obligation means that the parties are bound by rules or commitment, as distinct from non-legal norms. Second, precision means that rules unambiguously define the conduct they require, narrowing the scope for interpretation. Third, delegation to third parties implies that decisions are implemented by non-partisan courts, arbitrators, or administrative organizations. In contrast, "soft law" comprises legal arrangements that are weakened along one or more of these three dimensions (Abbot and Snidal, 2000). Rather than a black-and-white categorization, international agreements tend to occupy the whole continuum between hardest and softest law.

Soft law has a number of distinct advantages as a tool of international policy coordination (Abbot and Snidal, 2000):

- **Soft law facilitates dealing with uncertainty.** Oftentimes, it is difficult to anticipate all future consequences of an agreement, and for the enforcer to grasp fully the nature of the compliance. To accommodate this, agreements can be made less precise, or less legally binding.

- **Soft law is a tool of compromise.** The more diffuse the preferences and the more heterogeneous the states, the harder it is to come to an agreement. Soft law tries to accommodate "divergent national circumstances" by offering some element of flexibility.

- **Soft law lowers contracting costs.** Multinational agreements are often hard to reach. While hard law reduces the cost of operating within an already-agreed legal framework, a softer arrangement is less costly to reach in the first place.

- **Soft law reduces sovereignty costs.** States are often loath to transfer power from the national to the international arena. Sovereignty costs are particularly marked when a state accepts a higher degree of delegation to an external authority, such as the European Court of Justice.

In fact, the EU now leans heavily on soft law in many aspects of economic policy coordination. Traditionally, decision-making was centralized, and the Commission was endowed with a significant agenda-setting role. The liberalization of product markets, under the auspices of the Single European Act, broadly followed this pattern. Partly in response to perceptions of excessive centralization, the Maastricht Treaty deliberately embraced the principle of subsidiarity, which allows for greater country autonomy. Different aspects of EU policy coordination occupy different areas of the hard-soft scale (Begg, Hodson, and Maher, 2003). While hard coordination emphasizes top-down policy formulation and financial penalties for non-compliance, the softer approach uses guidelines and codes, peer review, and benchmarking—an example being the open method of coordination underpinning the Lisbon agenda (Hodson and Maher 2001).

The SGP combines elements of hard and soft law. Multilateral surveillance under the preventive arm of the Pact is firmly rooted in soft law, as enforcement relies on peer pressure and sanctions are not legally binding. The EDP is somewhat "harder". The Treaty creates a firm "obligation" for countries to respect the deficit limit, despite a number of escape clauses. Non-compliance invokes legal responsibility. In terms of "precision", the 3 percent condition can be pinned down, whereas the medium-term objective requires an *ex post* evaluation, relying as it does on the complex calculation of cyclically-adjusted balances. Finally, given the ultimate authority of the ECOFIN Council in judging programs, issuing early warnings, and initiating and escalating the EDP, the extent of "delegation" of interpretation or implementation to a designated third party is limited under all aspects of the SGP.

61. **But soft law enforcement did work for a core group of countries.** These criticisms downplay the achievements of the numerous countries that did enforce the preventive arm under the SGP, even if the cooperation incentive was not a major motivating factor. As seen, the incentives for self-enforcement were clearly at play in commitment countries, in volatile countries, and in small countries. For different reasons, these countries possessed incentives to live up to SGP commitments. Small countries were more accepting of external peer pressure and were more likely to lose reputation in the event of non-compliance. Commitment countries faced greater domestic political costs for violating an agreed fiscal contract. And volatile countries likewise saw the advantages of a credible external anchor. Moving forward, it will be key to devise incentives so that the remaining countries will be more willing to enforce the Pact, at both the preventive and dissuasive stages. At the same time, any changes must not reduce the incentives to the current good performers to comply.

62. **In this vein, some of the reforms to the preventive arm are not encouraging.** The added flexibility may allow countries to deviate from their medium-term objectives for extended periods and remain in compliance with the Pact, despite the emphasis on a minimum ½ percent of GDP annual adjustment under the new guidelines. In effect, the disciplining effect of the external anchor could weaken. Although the differentiation of targets by country is a nod toward greater ownership, legitimacy can suffer if transparency and accountability are lower. The preventive arm needs to be simple and transparent, retain appropriate policy ambition, and not morph into a series of individual country rules (Annett, Decressin, and Deppler, 2005). The following in particular present potential problems:

- Countries can set their own MTOs which need not be CBS. In particular, making allowance for potential growth in setting MTOs could lead to targets that are too lax for the new members, given that they are also prone to higher macroeconomic volatility.

- Countries may deviate from their MTOs or adjustment path towards the MTO if they undertake structural reforms expected to yield direct long-term cost savings, including by raising potential growth. This has the potential to be open-ended, especially since the final agreement abandoned the proposal that such reforms at the very least be associated with short-term costs (Deroose and Langedijk, 2005).

- Although countries are supposed to avoid procyclical loosening by adjusting more in good times, this requirement is dampened by the definition of good times in levels instead of growth rates. Given the agreed-upon methodology, negative output gaps are far more common than positive ones.

Thus countries could have the ammunition they need to justify extended deviations from their MTOs, and little medium-term adjustment. This does little to encourage better soft law enforcement among any group of countries. Everything will depend on implementation.

63. **The reforms to the dissuasive arm are less problematic, but risks remain**. A case can be made for "softening" the dissuasive arm, to allow it to better distinguish between the effects of poor policies and weak economies and reserve sanctions for egregious policy misbehavior. This is indeed the flavor of the reforms. A more economically rational Pact could bolster legitimacy, and need not have any adverse implications on the preventive arm. But some believe that hard sanctions would become less credible if the SGP became too flexible, as the likelihood of being hit with sanctions diminishes (Hodson and Maher, 2004). But greater credibility could also increase the probability of self-enforcement, while the specter of the ultimate sanction would continue to cast a pall over countries' fiscal policy. Others (such as ECB, 2005) take a tougher line on the dissuasive arm reforms, as they believe it could weaken the all-important 3 percent anchor, which is crucial in anchoring expectations and facilitates monitoring (Schuknecht, 2004). Indeed, the potentially open-ended use of "other relevant factors" could raise the bar above 3 percent for countries to face the procedure, or lead to unjustifiably long correction periods. Again, implementation will be key.

64. **At the same time, the general approach of increasing national ownership is the right one.** If soft law enforcement is key, then the focus of reform in those countries less amenable to the external anchor role of the SGP should be on domestic institutions. Although the recent SGP reforms increase ownership across a number of fronts[19], they are relatively light on governance issues. In a nutshell, there needs to be come cost of non-compliance, and in the soft law domain, this cost is predominantly reputational, both within the country and among peers. So far the governance mechanism underpinning the SGP has relied on peer pressure driven by the center ("top-down"). For this to continue to function for a core (and growing) group of countries, there must be a perception of transparency and evenhandedness. For the other countries, it may make sense to rely more on "bottom up" peer pressure whereby non-compliance generates domestic opposition and entails a reputational cost. This makes sense in large countries less amenable to outside influences. It is also compatible with budgetary institutions based on delegation, a less rules-based and more domestically-oriented form of governance.

65. **In the first instance, countries could be encouraged to strengthen or reform their underlying fiscal institutions.** As many did in anticipation of EMU, countries could adopt, or strengthen, the form of fiscal governance most suitable to them. Although often downplayed, institutional reform was a theme in the Maastricht Treaty, which—in its EDP protocol—calls for member states to "ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from the Treaty". Indeed, the

[19] Examples of increased ownership in the new SGP include: (i) counties set their own MTOs and explain any deviation from it; (ii) Stability Programs are discussed in parliaments; (iii) countries must assess the roles of structural reforms (preventive arm) and "other relevant factors (dissuasive arm); (iv) national budget rules should be aligned with Stability Program requirements.

reformed SGP does call for fiscal rules to be made compatible with Stability Program objectives. Commitment countries in particular could increase reliance on formal rules to instill fiscal discipline, especially to stem procyclical pressures to loosen policies in good times. Some have suggested complementing the SGP with such national rules as expenditure ceilings (Mills and Quinet, 2002), a system of rainy day funds (Buti, Eijffinger, and Franco, 2003), or internal stability pacts between central and local governments (European Commission, 2003).

66. **More generally, reputational costs could be increased by relying more on domestic independent institutions.** Countries could rely on non-partisan fiscal councils aimed at securing independent assessments of fiscal policies that are subject to parliamentary authority. Under the SGP framework, such watchdog bodies would monitor compliance with the Stability Programs and help appraise fiscal policy. They could provide a more forward-looking perspective, help rally support for adjustment, and better identify policy failures. They could also guard against the array of non-transparent and short-termist tendencies—including unrealistic assumptions and constant revisions of targets; electorally-motivated loosening; reliance on one-off measures and creative accounting gimmicks; and even misreporting—that have dogged in the implementation of the SGP in some countries. Also, these bodies could help coordinate fiscal policy across different levels of government in countries where local governments possess substantial fiscal autonomy. If credible, a negative report from these councils could lead to reputational costs for the government.

67. **Ownership would be enhanced by having these independent councils report to parliaments, which would assume a greater oversight role in SGP compliance.** Reports by these councils, as well as the Stability Programs themselves, could be subject to parliamentary debate together with national budgets. In this light, the recent SGP reforms which call for Stability Programs to be debated in parliaments are a step in the right direction. Along similar lines, Gros, Mayer, and Ubide (2003) suggest that governments should be compelled to testify before their own parliaments following a negative report from the Commission.

68. **Going further, these bodies could provide independent macroeconomic and fiscal projections.** Ideally, these domestic institutions would prepare the macroeconomic forecast undergirding the budget and the Stability Program, as well as baseline fiscal projections and estimates of yields from announced policy measures. More specifically, they could also assess the likely yield from measures adopted under the EDP, thus fostering realistic adjustment. At least until such time as the independent councils are well established, countries could use Commission forecasts when formulating budgetary policy.

69. **Some go even further and suggest endowing such a non-partisan council with the power to set fiscal policy targets.** Pointing to the success of the committees guiding monetary policy in inflation-targeting central banks, Wyplosz (2005) recommends passing responsibility for setting annual budget balances to a council of independent experts, a fiscal

policy committee, with the aim of ensuring sustainability. The advantage lies in replacing numerical targets ("dead rules") with judgment ("living bodies").[20] In the context of EMU, countries would propose their own targets, which would be negotiated with other members, and the targets would be enforced by the national fiscal policy committees. There are also proposals for an EU-wide version of this kind of committee: Fatas and others (2003) argue that a Sustainability Council should be established, which would assess the consistency of countries' fiscal plans with sustainability, asking for adjustments if necessary.

70. **Independent fiscal councils of various hues exist across European countries.** In Belgium, the High Council of Finance recommends fiscal targets and provides normative policy assessments (Hallerberg 2004; IMF, 2005). Likewise, Denmark's Economic Council—representing trade unionists, employers, the central bank, the government, and academics—evaluates both fiscal and structural policies, making recommendations where needed (IMF, 2005). Some countries—including Austria, Belgium, and the Netherlands have also assigned the preparation of economic assumptions and projections to independent bodies (Jonung and Larch, 2004).[21] No country, however, has granted responsibility for setting fiscal policy targets to independent bodies. This hard form of fiscal agency would face daunting implementation hurdles given the implications for democratic accountability (IMF, 2005). Also, going further and setting up a supranational version of an independent council could overlap too much with the Commission's responsibilities.

71. **The limited experience with independent fiscal councils has been positive, offering lessons for other countries.** Institutional arrangements in countries like Belgium and Denmark contributed to a turnaround in fiscal policy (Hallerberg, 2004; IMF, 2005). There is also ample evidence that independent forecasts can eliminate systematic forecast biases which could otherwise feed through to deficit biases; Jonung and Larch (2004) show that forecasts from countries with independent agencies tend not to have statistically significant biases.[22] IMF (2005) argues that, for an independent council to be effective, it should proffer normative assessments of policy, and not just impartial analyses of government policy, given that the political cost of ignoring a purely advisory body is limited. Moreover, fiscal agencies of this sort can complement the role of pre-existing institutions,

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[20] Similar proposals come from von Hagen (1998), who suggests a National Debt Board that would enforce an upper limit on the growth of public debt.

[21] This varies from an informal agreement in Austria to a formal requirement in Belgium. In Belgium, the Federal Planning Bureau provides forecasts. In the Netherlands, the Central Planning Bureau is charged with producing independent economic forecasts and monitoring the state of public finances.

[22] Outside Europe, Mühleisen and others (2005) show that Canada—which uses macroeconomic projections from a range of private sector and academic forecasters—tended to have cautious projections, leading to larger-than-expected fiscal surpluses.

including fiscal rules, as they provide a clear benchmark against which policy can be assessed. Clear lessons can be drawn from this experience. Based on domestic institutions, this kind of institutional reform should be compatible with large and delegation countries, as they are more comfortable with domestic governance mechanisms. By bolstering reputation costs, it could aid with enforcement of the SGP, a pre-existing rules-based framework, in the soft law domain. Also, it is precisely the delegation countries that have the worst record in setting conservative forecasts, suggesting that these countries could gain from the use of independent projections.

VII. CONCLUSION

72. **This paper has argued that the SGP matters for Europe, and will continue to be important in the years ahead as the union expands.** For most countries, optimal fiscal policy is to aim for underlying balance (or close to it), allowing free play for automatic stabilizers; this is what the preventive arm of the SGP is geared to achieve. But politically-induced distortions often lead to deficit biases, necessitating a rules-based fiscal framework. And indeed, despite some headaches, fiscal policy under the Maastricht and SGP frameworks was an improvement over the past. At the current juncture, the looming demographic shock makes fiscal probity more urgent than ever. The SGP has worked especially well as an external anchor, reinforcing domestic institutions in a number of countries, typically those that are small, subject to greater macroeconomic volatility, and more inclined to use a rules-based form of fiscal governance (commitment). For a variety of reasons, these characteristics are well-suited to the institutional setup of the SGP. The new members are even more likely to share these traits.

73. **Enforceability and ownership should continue to guide SGP reform.** Reform should be gauged along a simple yardstick: it should not undo the external anchor for the countries that need it, and it should provide more incentives to adjust in countries that rely more on domestic governance institutions—including those that are large, less open and subject to external shocks, and more likely to rely more on discretion in fiscal policy setting (delegation). It would certainly not be in the interest of these countries to neuter the SGP, simply because its institutional framework as in imperfect fit with domestic governance. One strategy would be to increase the reputational costs of non-compliance with the SGP, by setting up independent fiscal councils, responsible to parliaments, to vet fiscal policy under the framework and make the public case for adjustment. If implemented seriously, this approach, relying as it does on domestic institutions, could work well in precisely those countries that had problems enforcing the SGP in the past. Complemented with the existing reforms that stress more ownership and country-specific economic underpinnings, this approach could be a fruitful one for fiscal policy in Europe.

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