

Evaluating the reform of the stability and growth pact: new and better?

A pesar de la reforma del Pacto de Estabilidad y Crecimiento (PEC) ocurrida en 2005, la aplicación real de las normas vinculantes de disciplina fiscal en la Unión Monetaria Europea sigue resultando muy polémica, tanto en el ámbito académico como en el político, incluso a pesar de que algunas de las críticas lanzadas contra el PEC original se han incorporado al PEC reformado. El objetivo de este artículo es evaluar los cambios acaecidos en la reforma de dicho Pacto, teniendo en cuenta las propiedades de las normas fiscales “ideales” de Kopits y Symansky. Nuestro estudio defiende un evidente aumento de la flexibilidad, pero advierte de la posible aparición de problemas de aplicación y la falta de avances en la coordinación de las políticas fiscales nacionales. En este contexto nos planteamos la necesidad de nuevas mejoras a escala europea en la definición y puesta en marcha de las políticas fiscales nacionales.

Egonkortasun eta Hazkunde Hitzarmena (PEC) 2005. urtean eraberritu bazen ere, diziplina fiskalaren arloan lotesleak diren Europar Moneta Batasunaren arauak garatzeak garrantzia izaten jarraitzen du, eta gatazkatsua izaten ere bai, bai arlo akademikoan eta baita politikoan ere, nahiz eta erreforma horrek beharbada kontuan hartu PECaren hasierako testua kritikatzeko zutenek egindako zenbait ekarpen. Artikulu honen helburua hitzarmen hori eraberritzean izandako aldaketak ebaluatzea izan da, baina Kopits eta Symansky-k arau fiskal “idealek” izan beharreko ezaugarriak buruz esandakoak kontuan izanda. Gure azterlanak malgutasuna nabarmen handitzearen alde egiten du, eta horrekin batera, aplikatzeko beste arazo batzuk agertu direla eta politika fiskal nazionalak koordinatzeko prozesuan ez dela aurreratu erakusten du. Testuingurua hori izanik, beste hobeak batzuk egin beharra dagoela esaten dugu, Europar estatuetakoko politika fiskalak definitu eta garatzeko.

In spite of the recent reform of the Stability and Growth Pact (SGP) and the fact that some of the questions raised by those who criticised the initial framework for fiscal discipline may have been considered, the discussion on the implementation of binding fiscal rules in the European Monetary Union is still a matter of important controversy in both academic and political fields. The objective of this paper is to evaluate the changes contained in the reformed SGP by taking into consideration the properties for “ideal” fiscal rules put forward by Kopits and Symansky. Our analysis points towards a clear increase in flexibility together with the probable emergence of new enforcement problems and no advances in terms of the coordination of more effective fiscal policies. In this context, we discuss the need for new improvements within the European framework for the definition and implementation of national fiscal policies.

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JEL Classification: H62, H63, H77.

1. INTRODUCTION

The creation of an Economic and Monetary Union involves the loss of important instruments of national public intervention, given that monetary and exchange rate policies are transferred from the sphere of national decision to the level of community decision.

The same situation does not necessarily occur in terms of the definition and implementation of fiscal policy, which can be maintained under the jurisdiction of the national authorities. In this case, it becomes the only instrument at their disposal for interventions aimed at conjunctural stabilisation. Alternatively, a marked degree of centralisation could be observed at this level, reducing national governments' margin of control even further and transferring competences in that field to a "central" government.

The solution adopted within the framework of the European Monetary Union (EMU) was to maintain fiscal policy autonomy while limiting the space for creating public deficit and extending public debt through the adoption of (compulsory) fiscal rules, possibly complemented by the coordination of national fiscal policies.

This option was clear in the Maastricht Treaty and it was reinforced by the Stability and Growth Pact (SGP, European Council, 1997). It has also been the object of strong criticism, both from politicians and academics, which has been partly taken into account in the recent SGP reform (European Council, 2005). In spite of this reform, the subject of fiscal discipline within the euro area remains one of the most controversial in both political and academic fields, so keeping an important interest to be discussed.

An evaluation of the reformed SGP is thus the fundamental point of this paper,

the main idea being to analyse whether the reform means a truly “new” and “better” way to implement fiscal discipline within the euro area. In sections 2 and 3, we briefly present the main characteristics of the European solution for fiscal discipline and outline the main contours of the discussion, with a particular emphasis on the major changes of the recent reform of the SGP and the previous proposals intended to better it. In section 4, we refer to the properties put forward by Kopits and Symansky (1998) for defining “ideal” fiscal rules, as well as some criticism to that set of properties. In section 5, we assess the main changes that have occurred as a result of the SGP reform, by classifying the reformed and the original SGP in the light of the mentioned criteria. In section 6, we conclude and present some elements for further analysis, discussing possible improvements in the framework for fiscal policies in the euro area.

2. FROM MAASTRICHT TO THE REFORMED SGP

The Maastricht Treaty (1992) established the framework for fiscal policy within the EMU: it remained as a national competence, but limited by binding fiscal rules, which should be complemented by coordination.

The option sanctioned by the Maastricht Treaty was later reinforced through the signing of the SGP, following strong German pressure. It introduced a medium term objective for national public accounts — a situation of equilibrium or even a slight surplus, in order to ensure some margin for manoeuvre in the event of a negative shock — and concrete sanctions to be applied in the case of the maintenance of excessive deficits by a Member-State.

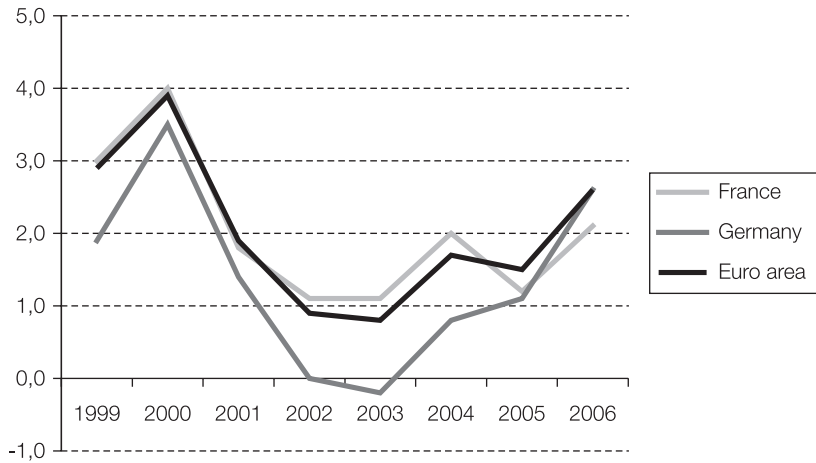
This solution has been the object of deep discussion and criticism in political and academic circles. This did not generally involved questioning the need for fiscal discipline, taken as an essential element for creating a favourable environment regarding to stability and economic growth and as a means of avoiding negative external effects resulting from deficient budgetary behaviour (De Grauwe, 2005). Instead, the discussion has been centred round the way in which this discipline should be implemented and controlled, doubts and criticisms being extremely varied in relation to the adopted solution (e.g., Buiter *et al.*, 1993; Rubio and Figueras, 1998).

Between 1996 and 2000, this type of criticism diminished, in a context marked by the optimism related to the creation of the EMU and by an economic upturn (Fig. 1).

Nevertheless, at the beginning of the present century, critical discussion came to the fore once again as a result of the economic difficulties felt by some of the major States (namely France and Germany) and of the growing belief that the solution adopted in terms of fiscal discipline could, in fact, be hindering a more effective fight against the negative effects of the economic crisis, or even worsening the difficulties.

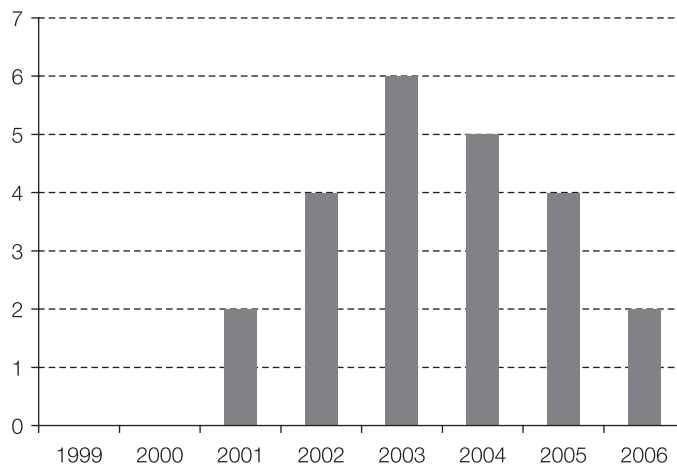
The fact that a growing number of countries were not able to fulfil the criterion relating public deficit to GDP also generated (Fig. 2), in this period, a rising number of political and academic voices in favour of a SGP reform. These opinions pointed for greater flexibility in the rules and a greater balance between nominal and real objectives and culminated in the classification of “stupid” being attributed to the SGP by the President of the European Commission at that time, Romano Prodi.

Figure 1
GDP real growth rate
(%)



Source: OCDE, Perspectives économiques, December 2006.

Figure 2
Number of countries with public deficit above 3% of GDP



Source: OCDE, Perspectives économiques, December 2006.

The request for greater flexibility was mainly based on the idea that a restrictive fiscal policy in a context of crisis would be counter-productive: in this context, the simple work of the automatic stabilisers probably generates higher budget deficit; if the government responds to this through budget cuts, it makes the economic crisis worse, and in doing so, it may aggravate budgetary problems even further. On the other hand, there was no exceptions for situations of accumulated production loss resulting from periods of stagnation or low economic growth, as sanctions were not applicable only for situations of real GDP growth of no lesser than -0.75%/year. Third, the time period for correcting situations of excessive deficit would be too short, highlighting the undesirable pro-cyclical tendency of the restrictive policies to be taken.

These criticisms were also supported on the fact that even some major economies of the euro area were facing difficulties in order to fulfil the public deficit criterion. In fact, for some years, France and Germany had a public deficit above 3% of GDP (Fig. 3) and some concern were raised on the application of sanctions to these countries, as it would probably worsen the situation for the entire euro area, by means of negative spillovers.

The suspension of the SGP for these economies, which occurred in November 2003 (European Council, 2003), determined the demise of its original form and the appearance of a reformed SGP after March 2005 (European Council, 2005). From the above mentioned facts, it should be stressed that political issues had a major influence in this reform, their importance being as great as (or even greater than) academic discussions around the topic of fiscal discipline within the EMU.

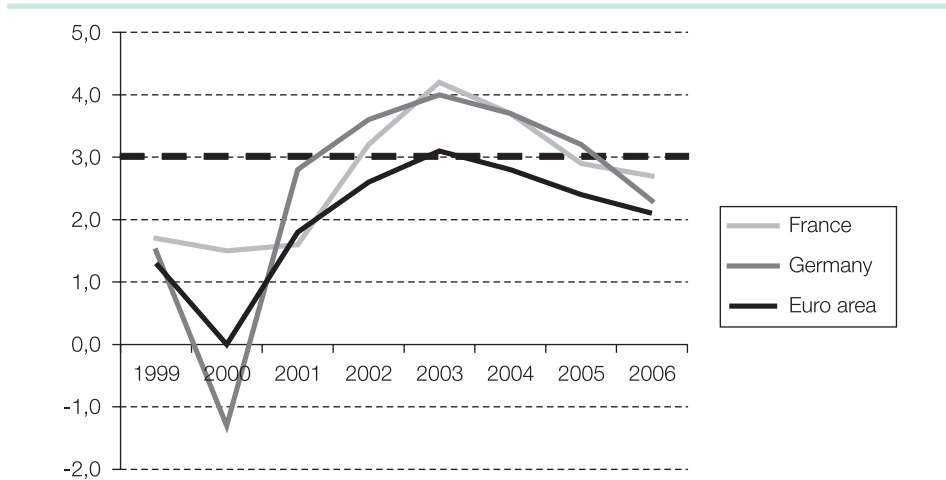
3. THE REFORM OF THE SGP: MAIN PROPOSALS AND CHANGES

The inversion of the economic situation by the beginning of the present century and the worsening of real problems, associated with the loss of competitiveness and employment, renewed debate and criticism, both in the academic and political field.

This discussion culminated in the SGP reform, with the aim of greater flexibility of application, without affecting the maintenance of fiscal discipline. In the context of this reform, the following was established:

- (i) an extension of the period for implementing and making effective the measures for correcting excessive deficits, possibly up to 4 (or even more) years, instead of 1 and 2 years as it was before;
- (ii) the relevance of the structural correction in periods of effective product growth above its potential level, taking as a reference the decrease in structural deficit by around 0.5%/year, enabling more margin for manoeuvre in periods in which economic difficulties arise;
- (iii) the attribution of greater relevance to the criterion relating to the proportion of public debt to GDP (practically ignored until now), as a means of assessing the sustainability of the budget position in the medium and long run;
- (iv) the extension of circumstances that would allow no application of sanctions, by considering situations of negative growth of real GDP (instead of -2%) and including

Figure 3
Public deficit to GDP ratio
(%)



Source: OCDE, Perspectives économiques, December 2006.

situations of accumulated production losses during an extended period of considerably weak growth in relation to potential growth;

- (v) the possibility of including different “pertinent” factors when taking decisions on the situation (or not) of excessive public deficit, enabling the consideration of various forms of public expenditure as justifying factors for a public deficit ratio superior to the maximum limit (namely expenses in areas such as defence, social security reform, policies supporting innovation, research and development, European reunification — particularly in the case of Germany —, etc.).

made to the original SGP may have been taken into account at the time of the reform, namely:¹

- (i) the idea of having “pertinent factors” could be related to proposals such as those presented by Mills and Quinet (2001), Brunila (2002), von Hagen (2002), Fitoussi and Creel (2002) and Creel (2003); these authors have proposed the introduction of a rule relating to the composition and quality of public expenditure or the change to the so-called “golden rule” of public finance;
- (ii) the greater importance given to structural situation may be, to some extent, related to the proposal

It is worth to note that some of the criticisms and reform proposals previously

¹ More detail on these proposals may be found in Alves and Afonso (2007).

presented by Buiter and Grafe (2004), who claimed for a change in assessing structural balance; note, however, that in their proposal this would be done by introducing the concept of “permanent balance rule”, i.e., the difference between the average long-term future value of fiscal revenue (constant) and public expenditure;

- (iii) the renewed importance given to the situation of public debt may also be, to some extent, linked to the concerns raised by Pisani-Ferry (2004), who suggested the introduction of a Debt Sustainability Pact; such a pact would oblige the presentation of medium-term programmes that would reveal the medium-term objectives for the proportion of public debt to GDP and would enable the States in which this indicator was less than 50% to be exempt from the procedures of excessive deficit and the associated sanctions; fiscal discipline would thus be oriented according to a longer time perspective and based on the long-term sustainability of the budget situation.

Other more radical proposals seem to have not been considered, among them:

- (i) Casella (1999) proposed that the aggregate budget balance of the euro area should be taken into account, together with a market system of deficit assignment;
- (ii) several authors, including Wren-Lewis (2003), von Hagen (2002) and Wyplosz (2005), suggested to reinforce financial market discipline and to adopt procedural and

institutional reforms; for instance, Wyplosz (2005) asked for the creation of independent “National Committees for Fiscal Policy”, responsible for ensuring supervision of fiscal discipline and debt sustainability;

- (iii) adopting a Keynesian point of view, Arestis *et al.* (2001) suggested the strengthening of the coordination of national fiscal policies, together with institutional changes in order to ensure that the monetary authorities were not in pre-eminent positions to dominate the EU macroeconomic policy;
- (iv) considering that there is an inherent conflict between national and European interests due to failure of the principle of fiscal equivalence in the SGP, Collignon (2004) argued for the creation of an European government as the only way to solve it.

4. THE CRITERIA OF KOPITS AND SYMANSKY: PRESENTATION AND CRITICISM

An analysis of the need (or not) for changes to the original SGP and of the possible improvements introduced with its recent reform can be made by considering the classification put forward by Kopits and Symansky (1998), concerning the definition of “ideal fiscal rules”. Reasonable consensus for this classification has been reached among authors with different positions regarding the kind of rules and their supporting indicators (*e.g.*, Buti *et al.*, 2003; and Creel, 2003).

According to this classification, for a set of fiscal rules to be seen as “ideal”, they would have to be:

- (i) “clearly defined” in terms of the indicators to be used, the institutional cover and the specific escape clauses, in such a way as to avoid ambiguities and deficiencies in practical application;
- (ii) “transparent” in terms of the set of governmental operations, including accounting, forecasting and institutional arrangements, so as to obtain “popular support”;
- (iii) “simple”, so that they could be fully understood by the public;
- (iv) “enforceable” in the sense that there are legal or constitutional rules through which to enforce them, as well as credible sanctions for cases of non-compliance and the definition of the competent authority to apply them;
- (v) “flexible” in order to deal with exogenous shocks, i.e., situations beyond the authorities’ control;
- (v) “adequate” in relation to the specific objectives;
- (vii) “consistent” with each other, as well as with other macroeconomic policies and other policy rules;
- (viii) “efficient”, so that they could be seen as catalysts of fiscal reform that would be, to a certain extent, necessary to ensure the sustainability of the budget position.

These eight requisites cover a mixture of economic and political concepts. In particular, the first four are of a more

political nature, while the other four are more economic in nature. On the other hand, not only is it difficult for any set of fiscal rules to meet the eight requirements, but some trade-offs are inevitable between them: at the economic level, for example, between transparency and flexibility or between simplicity and possibility of application; at the political level, for instance, between transparency and simplicity.

In any case, they are based on a set of target properties for defining fiscal rules and making them credible, and in each concrete case, a choice will have to be made according to preference for some of these requirements: “choosing among the alternative trade-offs remains a political choice” (Creel, 2003, p. 6).

It must also be taken into account that this classification was put forward in order to assess the quality of fiscal rules within a national framework. As stated by Buti *et al.* (2003), the multinational nature of the rules in the European case affects their design and implementation. On the one hand, there are questions related to subsidiarity and to national sovereignty, implying that the rules must be as neutral as possible in view of the social preferences of each Member-State. On the other hand, the nature and relevance of the mentioned trade-offs may differ: for example, with the consecutive enlargements of the Union, the heterogeneity and dispersion of preferences have increased and it has become even more difficult to find optimal uniform fiscal rules.

It should also be noted that in the case of the euro area, the situation also differs from the analysed by Kopits and Symansky (1998) because of the actual nature of the

area. In fact, since there is an advanced process of monetary integration among different countries, the incentive for coordination given by the framework (and its rules) for fiscal policies would also be an item to consider in order to decide whether such framework is adequate.

For instance, the theory of optimum currency areas clearly states the desirability of some coordination of fiscal policies. In this context, the importance of the criterion of “consistency” should be enlarged and take into account the existence, within the framework for fiscal discipline, of a true incentive for coordination, something that goes beyond the original definitions of Kopits and Symansky (1998).

5. AN EVALUATION OF THE REFORM: NEW AND BETTER?

Now we turn to the main objective of this paper: to evaluate the SGP reform, in order to see whether the implementation of fiscal discipline has really changed and whether it became more adequate. This is done by taking into account the properties defined by Kopits and Symansky (1998), through a methodology previously used by authors such as Buti *et al.* (2003) and Creel (2003), although in order to assess the performance of the original SGP.

Table 1 shows our assessment of the performance of both versions of the SGP. It should be noted that, in what relates to the original SGP, our classification is close to that proposed by Creel (2003) and, as it is below clarified, it is very different from that proposed by Buti *et al.* (2003), based upon which only slight changes to the SGP rules would be justified.

An overall view of Table 1 would lead us to conclude that, with its recent reform, the SGP has become more flexible, but not necessarily more adequate in terms of assuring fiscal discipline in the euro area. In fact, its classification would be better than that of the original in terms of “flexibility”, but eventually worse in terms of criteria such as “enforcement”, “transparency” or “efficiency”².

Now we turn to the comparison for each of the criteria with some more detail:

1) *Clear definition*

In terms of the used indicators and the institutional cover, both versions seem to be clearly defined, avoiding ambiguities and deficiencies in their practical application. However, as the number of specific escape clauses seems to become excessively large in the reformed Pact, it is possible that the application of this one becomes not so unambiguous: that is why we reduced the classification from “good” to just “adequate”.

2) *Transparency*

Some of the circumstances that are admitted to allow an excessive deficit by the reformed SGP seem clearly pertinent, namely with regard to some public investment expenses or in relation to the clearance for certain kinds of structural reforms at the level of social security.

However, the exaggerated number of escape clauses together with the creation

² Please note that our evaluation of the original SGP is *ex-post*, incorporating a number of known events and results that emerged after its creation. The same does not apply to the reformed SGP, at least to some of the criteria: as the system was not put under stress after 2005, the evaluation is more likely *ex-ante*.

Table 1
Comparison of the original SGP with the reformed SGP (2005)

"Ideal" fiscal rules	SGP (1997)	SGP (2005)
(1) Clearly defined	++	+
(2) Transparent	+	–
(3) Simple	+++	+++
(4) Enforceable	–	–
(5) Flexible	+	+++
(6) Adequate for the final objective	–	+/-
(7) Consistent	–	–
(8) Efficient	–	+/-

Key: +++ "very good"; ++ "good"; + "adequate"; – "weak"

of an almost *à la carte* system, where each Member-State apparently would choose the most adequate "pertinent factor" (Alves, 2007), seems to raise new problems in terms of creativity at the level of public accounting.

In this context, the classification given to the reformed SGP is worse than that for the original, respectively, "adequate" and "weak".

3) *Simplicity*

Probably it would be difficult to adopt supporting indicators that were simpler than the ratios of public deficit over GDP and public debt over GDP. These are perfectly understandable to the general public and they remained the same after the reform. This is why we classified both the original and the reformed SGP as "very good" in terms of "simplicity". Note, however, that the case for the reformed SGP is weaker in this item, again because of the mentioned escape clauses.

4) *Enforcement*

The original SGP proved incapable of being "enforceable" or even of promoting some change in the behaviour of the transgressors by raising the costs of public debt subsequent to a loss of credibility. Particularly enlightening at this level are examples such as the suspension of the SGP, the fact that some countries successively transgressed the rules without being sanctioned or the null impact on long-term interest rates when Ecofin adopted an excessive deficit procedure for France in 2002/2003.

This has probably been one of the worst features of the original SGP, if we take into account the Kopits and Symansky's classification. Even Buti *et al.* (2003), who defended that the original SGP only needed slightly changes, agreed upon the necessity of increasing the capacity of enforcement of these fiscal rules. Note that other authors, especially those who were more sceptical about the Pact (e.g., Creel, 2000), had the same opinion as ours.

In our opinion, the situation has not been improved with the recent reform. In fact, the most negative element of such reform seems to be the excessive and particularly subjective number of attenuating situations for non-compliance to the maximum ratio of 3% between the public deficit and GDP. As before mentioned, some of these circumstances seem clearly pertinent, but, the inclusion of others, apparently at the choice of each Member in the euro area, raises new difficulties in the concrete application of fiscal discipline rules.

The apparently exaggerated set of escape valves could thus make the reformed version of the SGP even less “enforceable” than the former, eventually taking the classification from “weak” to a new type not included in our analysis (“very weak”). If so, the rating in other properties of the “ideal rules” would also be harmed, in particular in terms of the “adequate definition” and of the “transparency” as well as, under certain circumstances, of the “efficiency” and of the “adequacy” to the final objective.

It is worth noting that Buti *et al.* (2005) show, to some extent, similar concern, leading to a significant convergence between our appraisal and the assessment developed by these authors, which was not the case for the original SGP. At the same time, authors clearly critical of the original SGP also express concerns about the potential for opportunistic use of the exceptions and the fact that the true roots of the problem are not attacked (*e.g.*, Buiter, 2005; Coeuré and Pisani-Ferry, 2005; Allington and McCombie, 2007).

5) *Flexibility*

In the context of the original SGP, flexibility proved to be only apparent. It is certain that

the mechanism incorporated exception clauses and that it would be possible to let the automatic stabilisers act without going into transgression if Member-States began with an initial situation of balance. But the truth is that these clauses seemed to be too severe (for instance, remember that only an annual real decrease of the GDP for more than 2% would allow for the non sanctioning of an excessive deficit) and the starting point for some countries was already very close to the limit situation (so eliminating even the possible work of automatic stabilisers in the case of a negative shock).

In the case of the reformed SGP, both the extension of the period for correcting excessive deficits and the extension of the escape clauses, or even the possibility of considering different attenuating factors for a situation of apparent excessive deficit, seem to provide the States with a wider margin for manoeuvre in the event of a situation of exogenous shock, due to changes in circumstances that are beyond governmental control.

This is the main reason for a more favourable assessment of the reformed SGP in what relates to flexibility, going from a classification of “adequate” to “very good” (Table 1). The analysis made by Buti *et al.* (2005) points in the same direction, though within a somewhat different framework to the original analysis and even if the same authors defended, in 2003, a better classification than ours for the original SGP.

6) *Adequacy to the final objective*

In our opinion, it seems equally possible to give the reformed SGP a more favourable rating in this area, albeit with some doubts. In the past, several countries did not fulfil their stability programs and so the final

objective of debt sustainability was not reached. This would justify our negative classification, which is very different from that proposed by Buti *et al.* (2003) and even from that proposed by Creel (2003).

Now, if the renewed attention to fulfilment of the criterion relative to public debt is credible, some behaviour of creative accounting and of putting some expenses off-budget could be discouraged, as well as possibly raising the long-term sustainability of the budgetary positions. This explains why our qualitative classification would go from “weak” to “adequate”.

Note, however, that the number of countries for which public debt is still above 60% of GDP keeps high (6 in 2006, according to OCDE, 2006) and that for the entire euro area that value was above 75% (OCDE, 2006), meaning that important efforts might be necessary to assure debt sustainability. Also some doubts on the credibility of the mentioned change, taking into account its track-record and the reduction in the degree of “enforcement” (due to the inclusion of several attenuating factors), could make the classification to maintain its former negative value, explaining the final “undetermined” result in Table 1.

7) *Consistency*

In terms of consistency with other macroeconomic policies, the original SGP would fall short of what is desirable: (i) some of the countries did not fulfil their stability programmes and these would probably be the major elements for an eventual coordination; (ii) the Pact did not encourage coordination, as it did not change the complex and non binding framework defined in the Maastricht Treaty - in fact, the original SGP did not even refer explicitly

to coordination; (iii) the coherence between a counter-cyclical fiscal policy and a more expansionist monetary policy within a framework of low probability of inflationist consequences also does not seem to have been ensured. This idea is shared by Creel (2003), but not by Buti *et al.* (2003) for whom the effective respect for rules of the SGP would be sufficient to allow for policy coordination.

The same appears to be true for the new version of the SGP, since there continues to be no obligatory and sanctioned reference to the coordination of national fiscal policies. Consequently, there seems to be no reason for more effective coherence between the various national fiscal policies and between these and the common monetary policy. This happens in spite of the claim for a more strict coordination explicitly presented in the (dead?) proposal for a Constitutional Treaty (art. 15).

In this context, the classification could not be different from “weak” both for the original and the reformed SGP.

8) *Efficiency*

The original SGP proved a low capacity to encourage countries to carry out structural reforms and that has been one major reason for the impossibility of using counter-cyclical policies at a time of recession or of weak economic growth, except at the expense of transgressing the rules. Once again, our classification differs from that of Buti *et al.* (2003), who admitted an adequate efficiency for the original rules.

In what concerns the reformed SGP, efficiency may have been improved, leading to a change in our classification, from “weak” to “adequate” (or even “good”). In

fact, the reference to the importance of structural balance and the need for structural corrections in periods of effective economic growth above the potential level could lead governments to redouble their attention to the necessary taxation and public spending reforms in order to ensure the sustainability of public accounts.

In any case, the above-mentioned fact that the reformed rules could lead to too much flexibility might result in no particular change regarding the past situation, explaining why we finally consider the classification as “undetermined”.

6. IN CONCLUSION: NEEDING TO GO FURTHER?

In this paper we assess the rules of the reformed SGP, bearing in mind the properties established by Kopits and Symansky (1998) and the framework of the discussion of the last two decades on the method of implementing fiscal discipline in the euro area.

Our analysis clearly indicates that the changes that occurred in March 2005 have made the Pact more flexible, enabling more time for adjustment in the face of difficult budget situations and, at least theoretically, encouraging structural reforms and the good use of favourable economic situations in order to reorganise public accounts. Equally, by raising the number of circumstances in which sanctions do not occur “automatically”, including situations of stagnation or weak economic growth or favouring incentives to R&D activities,³ the

Pact has become a better “friend” of Growth, without harming Stability.

The main criticism now seems to centre round “enforcement”, since the fact that there is a vast set of factors that allow the non-classification of a deficit as excessive would seemingly lead to situations of less compliance and even to the repetition of creative and lax behaviour in some countries, just as in the past.

That would finally mean that the reformed SGP would not be “better” in terms of assuring fiscal discipline in the euro area: in fact, it could be more ‘stupid’ in terms of enforcement. For the moment, it is difficult to assess whether this may happen, as no very relevant shock has put the system under stress since its reform, contrary to what happened with the original. In any case, a negative aspect may be stressed, the fact that a large number of countries are still far from the medium-term objective of budget equilibrium.⁴

In this context, some suggestions could be put forward so as to enable some improvement in the conditions of SGP application: (i) the consideration of a relatively exhaustive list of expenses that could be considered “excludable” from the calculation of the relevant public deficit; (ii) reinforced vigilance in the efforts to improve public accounts in periods of economic expansion as a means of enabling a wider margin for manoeuvre for fiscal policy in periods of recession; (iii) the introduction of concrete greater attention to sustainability of the public debt, following one of the vectors of the reform and enabling it to move in the direction proposed by, among others, Pisani-Ferry (2004); (iv) particular

³ Note, for instance, that recently, Afonso and Alves (2006) suggested that temporarily excessive deficits should be allowed for the small and less developed countries within the euro area, in order to let the government subsidize R&D activities and, thus, reduce the level of development gap.

⁴ For the euro area (Fig. 3), public deficit meant more than 2% of GDP in 2006.

attention to the reforms in the scope of Social Security, which emerges as one of the fundamental areas for sustainability of public accounts in the medium run, in view of the problems arising from an unfavourable demographic evolution.

These suggestions would certainly improve the classification given to the fiscal discipline rules of the SGP. However, they would not end up the discussion on the ideal framework fiscal discipline within the euro area.

One of the most important issues that still are open relates to the question of how to provide an adequate policy mix in the context of the EMU. In our opinion, for the particular case of a monetary union, it will be very difficult to get an adequate degree of consistency only with the adoption of fiscal rules, even if they become well classified in terms of the former properties (including “consistency” — note, as mentioned before, that this classification was developed for the case of a single country).

In this context and admitting that a situation of great (political) difficulty will be maintained in promoting fiscal “centralisation”, the solution could involve a significant degree of fiscal policy coordination. In accordance with the relevant literature, this solution would tend to produce welfare gains when compared with non-cooperative solutions,⁵ although it would also continue to show some difficulties.⁶

It is worth noting that at the level of economic literature itself, the analyses on the coordination of monetary policies continue to predominate, with a much lower number of studies aimed at coordinating fiscal policies (and these with monetary policies), even though the European case has encouraged development in this area.⁷ In this context, this area appears to be potentially fertile ground in terms of future research.

Finally, it should be said that, despite the greater flexibility resulting from the change in some rules, it is not clear that an environment suitable for combating the negative effects resulting from specific or asymmetric shocks has been created. Within this framework, the creation of a limited mechanism of absorption of this type of shock could enable a more satisfactory solution, possibly without requiring a very significant budgetary increase.

Such a solution would result in an attempt to promote some form of “insurance”, typical of federations with single currency and advised, for instance, by the relevant literature in the context of the optimal currency areas. At this level, and for the European case, some proposals have been already made, namely following the pioneering works of Italianer and Vanheukelen (1992) and Italianer and Pisani-Ferry (1994), constituting another potential field for future research.

⁵ There is a great deal of literature on this subject, starting with the seminal works of Niehans (1968), Cooper (1968) and Hamada (1976).

⁶ Among others, see the arguments developed by Frankel and Rockett (1988), Miller and Salmon (1985), Maillet (1992) and Tabellini (1990).

⁷ Taking the case of the European Union as a base, it is worth consulting Beetsma and Bovenberg (2001), von Hagen (2002), Uhlig (2002), or Muscatelli *et al.* (2004).

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