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THE FUTURE OF THE STABILITY AND GROWTH PACT AS A TOOL FOR ECONOMIC POLICY CO-ORDINATION

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EXECUTIVE SUMMARY

The Stability and Growth pact, agreed at the Amsterdam summit in 1997, had, as its main objective ensuring the stability of the Euro zone to the strong currency Members States, despite the fact that it would include the Mediterranean countries. Therefore, it emerged as a mechanism to overcome the feeling of mistrust that existed at the time. In addition, it aimed at preventing free riding behaviour in the monetary union.

However, it only committed countries to a given deficit level without ensuring economic policy co-ordination as countries could not surpass the three percent threshold, aiming in the medium term to budget equilibrium, but it was left to Member States to decide what was the best way to attain that objective. However, given the absence of relevant elements of economic policy co-ordination, the stability and growth pact also started to assume that role, something that eventually led to its failure as it had not been sized up to perform that function. Nonetheless, the stability pact is important and should continue to pursue its role of ensuring fiscal discipline, especially in line with the demographic crisis. It should however have a more prominent role as far as economic policy co-ordination is concerned. Hence, it should be coupled with a rule inspired on the golden rule of public finance which would allow Member States to invest in Community competence areas, such as the ones agreed in Lisbon. The main objective of such a measure is to make public investment compatible with fiscal discipline. Indeed, fiscal discipline and public investment should not necessarily move in opposite directions, especially because economic growth and full employment are goals the EU tries to reach.

The lack of democracy of the stability and growth pact should not be used as a reason not to respect its rules. Indeed, the pact was agreed by all Member States. Despite this it should be more transparent and democratic so that it becomes more credible under the eyes of the public opinion. Hence, it is suggested that national stability and convergence programmes should be voted in National Parliaments before they are submitted to the Commission and also that the European Parliament should have a more active role when discussing, approving and monitoring them. The EP would be evaluating national stability and convergence programmes and would issue an opinion on each of the programmes. This should allow the only elected body in the EU to have a clear view on the compatibility of each national programme and on its relevance to the achievement of the EU goals.

Henceforth, the main conclusions of this paper are that the stability and growth pact should continue to exist and in order to be more effective when ensuring fiscal discipline, its sanctions mechanism should be reinforced. It should also pay closer attention to national debt values and a rule similar to the one governing deficit values should be created for debt levels. In addition, the SGP should be coupled with a different pact that would incorporate the golden rule of public finance whereby investments in line with the Lisbon strategy would be exempted from the deficit calculation. The bottom line is that countries should not be sanctioned if they invest in growth oriented projects. The crucial points would be to clearly define the items that should be included in the golden rule. That definition would have to obey a set of European criteria. The projects involved, proposed either individually or by more than one Member State, would be evaluated by an expert group set up by the European Commission which would make an opinion, the final decision would be taken by the Council which would vote on the basis of a Commission proposal.

INTRODUCTION

The stability and growth pact is one of the very few mechanisms that ensure the co-ordination of economic policies in the Eurozone. However, it has always been controversial. On the one hand, individual Member States are keen on preserving sovereignty of their fiscal policies, especially considering what has already been lost in terms of monetary policy. On the other hand, an economic and monetary union formed by twelve different countries implies that the actions of one Member State necessarily affect the others. That is one reason why economic policies need to be co-ordinated. Only more co-ordination can ensure more coherence between policies that ultimately would lead to a better policy mix for the whole of the EMU. That objective however is difficult to attain. The most recent events are living proof of that. Indeed, Member States did not hesitate to put European commitments at jeopardy to satisfy their domestic priorities.

The objective of this paper is to assess the future of the stability and growth pact as a tool for co-ordination of economic policies in the EU. In order to do that, this paper is organised in two different sections:

1. Section 1 assesses the main problems that surround the current stability and growth pact. Therefore and to begin with, the pact will be reviewed by covering various aspects, including what led to its creation, the evolution of economic activity and how the stability pact coped with an economic scenario different from the one which prevailed when it was created as well as the main problems and challenges underlying present and future European fiscal policy. The most recent events about the stability and growth pact will be discussed and the implications of these will be assessed. By analysing current economic data, this paper will also attempt to assess whether the stability and growth pact has been effective in ensuring the consolidation of public finances in the future member states.

2. In section 2, this paper will aim at proposing a new pact for the co-ordination of economic policies, namely by the introduction of the golden rule of public finances. This section will start with some proposals to reform the stability and growth pact. The golden rule of public finances and its possible advantages and disadvantages will be dealt with. Some proposals to reform the sanctions mechanism will be made. The

issue of whether the pact is democratic will be analysed and some measures will be put forward in order to cope with its lack of democratic legitimacy. Finally, the paper will discuss a more desirable framework for the co-ordination of monetary and fiscal policies within the EMU.

I – THE MAIN PROBLEMS OF THE CURRENT STATE OF AFFAIRS

1.1- The history of the Stability and Growth Pact

The stability and growth pact was formally agreed at the Amsterdam European Council in June 1997.

When the Maastricht criteria were defined, few expected that 11 countries would adopt the Euro immediately. The economic records of these countries were very different, with some countries showing a record of high deficits and high debt while others showed the opposite. Germany, for example, had traditionally been used to fiscal discipline and to a credible central bank (the Bundesbank). Therefore, German public opinion was reluctant to join such a large monetary union that would encompass traditionally less credible countries, such as Portugal and Spain, and the stability and growth pact was created to ensure that fiscal discipline would prevail.

In addition, a feeling of mistrust that existed among Member States also played a role. Indeed, some countries were reluctant to join a monetary union that would encompass all the Mediterranean countries. The record of these countries in terms of monetary policy was not brilliant and there was a fear that these countries once in EMU would behave as free riders, that is to say individual Member States would have an incentive to pursue their own policies irrespectively of the Euro, as the negative externalities that could emerge from the domestic policy would likely be dissolved in the other eurozone economies. This mistrust led to the creation of fiscal rules aimed at preventing such behaviour.

Moreover, the stability and growth pact had, initially, as its objective, the maintaining of fiscal policy stability. The addition of growth as an objective was the conclusion of a higher level discussion that culminated in attributing an objective (growth) to a mechanism (the stability and growth pact) but no means to achieve it. The stability and growth pact was hence created to act as a guardian of European public finances and not as a mechanism to foster European economic growth. Its economic rationale was that sound public finances would be conducive to long term economic growth, as it would create favourable conditions to lower interest rates that would increase investment, employment and eventually growth levels. However, adding “nice” objectives without the appropriate mechanism proved to be counter-productive. In practice, the absence of means to achieve economic policy objectives only makes economic policy more confusing, less transparent and consequently less credible.

Nevertheless, and despite the fact that the SGP was created mainly to answer German political concerns, it does have an economic reasoning behind it. Firstly, countries cannot indebt themselves endlessly, as future generations have to pay for the consumption of the present generation (in a situation where a deficit is caused by the State borrowing to finance consumption). Secondly, one of the purposes of the stability and growth pact was to avoid policy conflicts between monetary and fiscal policies. It aimed at preventing countries from running higher than desirable budget deficits (as could be tempted to do) in a monetary union, as the effects resulting from such a deficit would spread around the entire MU thereby diluting the negative effects in the domestic country. Furthermore, it was meant to ensure some economic policy co-ordination and together with the broad economic policy guidelines it provides the only economic policy co-ordination mechanism in the EMU.

Thirdly, sound fiscal policies can be conducive to growth in the long run. This may occur through two main channels: on the one hand they allow for a more stable economic environment which in turn facilitates a lowering of interest rates by the ECB that might imply an increase in investment levels; on the other hand sound public finances allow for a more efficient role for the automatic stabilisers when the economy has to face a downturn or a recession. Indeed, a full operation of the automatic stabilisers is very important especially when an economy in facing a downturn or is in recession. More recently, and due to the fact that some countries had surpassed the deficit ceiling allowed by the SGP (3%), those countries could not recur to the automatic stabilisers as they would otherwise have been able to do and were forced to reduce their deficit in a period when the opposite would have been the recommendable option.

Fourthly, Europe will face a demographic crisis in the future. The effects of this crisis are likely to be spread around most of the so called developed countries but will not have a symmetric impact among all. In fact and according to UN forecasts, in Europe the situation is likely to be worse than anywhere else, most notably the USA. This undoubtedly poses very important questions for the future of Europe as undesirable spending now might jeopardise not only the future need to finance pensions, but also the concept of social Europe as we now know it.

1.2- The current economic downturn: the worst possible reason to make the SGP more flexible

Europe has not been performing very well since 2001. During the last two years, Europe has been living in a situation of stagnation with nearly zero growth. Deficits went up in most countries as a consequence of the use of the automatic stabilisers. However, some countries were not able to let them play fully their role because they had already surpassed the deficit ceiling imposed by the stability and growth pact. Countries such as Portugal and more recently the Netherlands illustrate this point.

Moreover, employment has not been attaining the levels decided in Lisbon, investment has gone down, deficits rose in most countries and, as mentioned, surpassed the 3% limit in three of them. Besides, GDP growth went down for two consecutive three month periods, meaning the Eurozone officially entered in recession, although there have already been some signs of recovery. Inflation has been for most of the time above the two percent ceiling, and, some would argue, the ECB has not cut interest rates as aggressively as it should have[1]. Moreover, two of the countries that surpassed the deficit limit are France and Germany which represent the bulk of economic activity in the Eurozone.

The stability and growth pact rules nevertheless continue to be valid. Despite the current economic downturn and the most recent events, more precisely the last Eurogroup and Ecofin meetings (further reference to the outcome and impact of these meetings will be made later in this paper), countries are still constrained by the three percent limit imposed by the pact and should not surpass it. This means that the use of fiscal policy to foster the recovery is still limited[2]. However, it is not only the use of fiscal policy that is limited but also the action of the European Central Bank and therefore of monetary policy. One of the factors that limits

[1] Interest rates are now at 2%, their lowest level since the last world war.
[2] The use of fiscal policy to foster recovery is questionable given the time lag that exists from the moment when the decision is taken to the moment when it is actually implemented and starts producing results. The use of the automatic stabilisers is however important and desirable in order to cushion a recession/downturn and it would be beneficial for Europe if countries could fully use the automatic stabilisers.

the Bank's action are the constant demands by politicians for the ECB to lower interest rates, thus putting pressure on the Bank, which is a new central bank and needs to show credibility to the markets. One way by which that credibility is shown is by resisting politicians' demands. A second important factor that limits the action of the European Central Bank is the lack of commitment by some Eurozone countries to respect the rules of the stability and growth pact. By not respecting the rules and hence increasing their deficits, some countries do not allow the ECB to recur more to monetary policy, or worse, will force the ECB to ultimately increase interest rates to respond to higher inflation rates caused by higher deficits[3]. This clearly complicates achieving an efficient co-ordination between fiscal and monetary entities.

Henceforth and due to the existing limits to both monetary and fiscal policy, some core Eurozone countries have been pressing for the stability and growth pact to be made more flexible. This means that the SGP would be either temporarily put aside, since it would take into account the current German and French difficulties to cope with its rules, or it would simply cease to exist.

None of the options presented is positive for the future of European integration. The SGP, as seen before, was a compromise between all countries that were adopting the Euro[4]. It can indeed be argued that it is not an optimal mechanism but nonetheless it is something that was agreed on, and countries should not ignore it just because of the present circumstances. However, the behaviour of some countries that belong to the Eurozone has not been identical: on the one hand, some have been taking austerity measures, in a period where the opposite would be the advisable option, to cope with their European commitments, more precisely the stability and growth pact; while others have preferred to pursue national policies that go against the European established rules (SGP). Some assumed an attitude of confrontation towards the European Commission (France) and others were more cautious in their attitudes although the objective was the same (Germany). In any case, both countries pushed for the flexibilisation of the stability and growth pact so that it does not limit economic growth. Indeed, both France and Germany have been publicly calling for the pact to be adapted to the current economic scenario and have also been launching initiatives which aim at increasing

[3] The ECB has just presented its inflation forecasts for 2004 which predict inflation at 1.8% instead of 1.3%.
[4] Some other countries, although they preferred not to adopt the Euro, follow the stability and growth pact. This is the case of Sweden.

economic growth in accordance with the Lisbon strategy, namely by suggesting strong investments (not quantified) in training and research and development projects. Nonetheless, European commitments should not be changed every time some members of the club have difficulties coping with the rules. Instead, the pact should be reformed with a long term perspective, with the aim of avoiding a similar situation in the future and there is indeed room for improving and reforming the current system.

1.3- The most recent episodes concerning the SGP

The events around the stability pact that have taken place in the last months are not surprising. It started at the informal meeting that took place at the beginning of September 2002 which had as main point the announcement by the European Commission that economic recovery in the EU would be slower than initially expected; to be more exact the EU would grow "marginally less than 1%" that year against the 1.4% forecast before. The Commissioner, Pedro Solbes, also recognised that this slow recovery would have an adverse impact on the consolidation of the deficit objective for this year, namely due to a predictable loss of revenues. He also sustained that on an analysis that had yet to be done there would be an element of nominal deficit and one of "structural deficit", which is the deficit corrected for cyclical fluctuations.

Not surprisingly, on September 24th 2002, the European Commission proposed that the balanced budget objective should be postponed until 2006, justifying its decision with the slowing down of the European economy. It however stressed the point that countries needed to present a quantified strategy concerning the reduction of their structural deficit. The countries in question, Portugal, Italy, France and Germany, needed to reduce their structural budget deficit by, at least, 0.5% per year. On the same day, the Commission adopted its report on Portuguese public finances. This report was the first step towards the excessive deficit procedure (art. 104.3 of the Treaty) as the Portuguese deficit proved to be higher than expected, 4.1% (against the 2.6% originally forecast). The report also said that the deviation from the original forecast target could only be partially attributed to the external economic situation but that "the size of the deficit was about equal to government investment expenditure". The ECOFIN council, based on the Commission report, urged Portugal to reduce its budget deficit by 2002 and on November 6th, the Portuguese government announced it would freeze 50% of its spending in new acquisitions and current spending until the end of the year, in order to get back in line with the 3% budget deficit. This was a rather serious economic measure taken in a country that was forecast to grow, for the first time in the last 10 years, less than the EU average. Such a reduction was likely to have a negative effect on the growth potential of the country and to increase unemployment rates[5]. Moreover, the Commission has recently adopted the same procedure regarding Germany as its deficit was officially recognised as being 3.8% of GDP and also launched an early warning against France. Indeed, France will violate the SGP ceiling for the third consecutive year but French authorities did not show much willingness to bring the deficit down before 2005. In fact, last June, the ECOFIN Council recommended France to take all the necessary measures to bring its deficit back to 3%, at the latest by 2004. Despite that, the French Government predicted a deficit of 3.6% for 2004[6]. The Commission then proposed to the Council that it officially recognise that France had not respected its recommendation and should therefore be sanctioned. The Council was supposed to have analysed this issue on November 4th, but its decision was postponed to the November 27th meeting in a move to allow some extra time for a consensus to be found. Within a month, the ECOFIN could ask France to implement measures to correct the excessive deficit situation (following a Commission recommendation). If France would not take any corrective measures, sanctions would be imposed within a two month period. This would have been the normal procedure.

Germany also above the deficit threshold, has presented tax cut plans as well, in a move some consider essential to improve the growth potential of the German economy. Indeed, the German Government presented a comprehensive plan to increase employment levels that includes among other things a reduction in social security contributions as well as subsidies to the construction industries and credits to local authorities. However, given the time when it was presented the coherence between the stability and growth pact and economic growth incentive measures some countries prefer to take inevitably puts into question the stability and growth pact. Indeed, this lack of coherence between the policies followed by some Eurozone countries can damage the credibility of the Euro and reinforces the argument that so far the

[5] Indeed, Portugal managed to reduce its deficit and might be able to stay under the 3% threshold in 2004 as well but this is mainly due to extraordinary revenues and a consolidation of public finances does not seem to have yet occurred. Moreover, while in Europe unemployment is now steady, in Portugal it is supposed to rise until the first semester of 2004. Investment levels have also gone down, both public and private.
[6] This is the figure presented for the French 2004 budget.

Euro has succeeded as a currency but has not been effective in ensuring the co-ordination of economic policies between Member States.

The most recent developments at the last ECOFIN Council have created further problems for economic policy making and led to a split not seen before. Indeed, given the difficulties both Germany and France were facing, the European Commission decided to recommend to the Council to continue with the excessive deficit procedure against both countries but it conceded them an extra year to get in line with the pact rules. This last attempt to save the SGP was however not successful as both France and Germany, supported by all Member States with the exception of Spain, the Netherlands, Belgium and Austria, did not agree to further reduce their deficits, and the Council ended up by not endorsing the Commission's recommendation instead adopting a text proposed by the Italian Presidency, by which Germany and France pledged to respect the SGP but at the same time were not sanctioned both countries as they should have been, if the rule of the Treaty had been implemented.

Moreover, there were constant and public disagreements not only between the European Commission and France but also between France and small countries. Indeed, at the ECOFIN meeting in Stresa, the Dutch finance Minister said that "invoking particular circumstances" not to respect the SGP rules "was a complete nonsense". The Austrian Finance Minister said that "all the possible political creativity" would not be enough to see France as a case to justify the invocation of special circumstances. These public controversies are unnecessary and undermine not only the credibility of the countries in question but also damage the Eurozone as a whole, as it creates a credibility problem that affects the entire EMU[7]. Indeed, all these events clearly illustrate the need for more ex ante economic policy co-ordination in the Eurozone as the only possible and efficient mechanism to ensure a better policy outcome.

Therefore, a clarification of the mechanisms underlying the stability and growth pact is urgently needed in order to have a stability and growth pact that not only truly takes into account its growth component, but also acts as an effective mechanism of economic policy co-ordination, which has not been the case so far.

[7] One example of this is the impact that all the discussions around the SGP had on the Euro referendum in Sweden.

1.4- Clear implications of these episodes on economic policy co-ordination

1.4.1- Monetary versus Fiscal policy

1) It is known that one of the main difficulties of the current system lies in the fact that all Member States are governed by one monetary policy but each one has its own fiscal policy. Theoretically, this difficulty could be overcome, if Member States would efficiently co-ordinate their economic policies. By doing that, Member States would then aspire to a more engaging dialogue with the European Central Bank so as to achieve a more efficient policy mix. An efficient policy mix cannot be achieved if Member States do not effectively co-operate with each other and it will not be optimal without the involvement of the European Central Bank via a serious dialogue process. However, the ECB has always been sceptical when it comes to dialogue with Member States as it fears Member States would be tempted to influence politically the monetary policy the bank sets.

The recent episodes surrounding the Stability and Growth Pact have naturally raised even more doubts as to whether such an engaging dialogue can ever take place between monetary and fiscal authorities. Indeed, both the French and the German attitudes have created further difficulties to more economic policy co-ordination as there is now a precedent which legitimises national economic policies regardless of what should be seen as the effects of those policies on a common good which is the Euro. The public confrontational arguments by both those who want to carry their own polices, despite what had been agreed by all Member States and by those that are against such behaviour, has shown how fiscal policy is subject to a strong political bias, which is something the ECB as a newly created and independent central bank wants to avoid. Indeed, the recent ECOFIN solution regarding the SGP poses serious problems for economic policy co-ordination: what can initially be seen by the advocates of a more growth-targeted SGP as a positive step, since countries can now focus more on variables such as unemployment and growth irrespective of their impact on public finances, is actually damaging economic policy co-ordination and any forthcoming efficient policy mix. Indeed, the ECB will not be willing to take a step towards more economic policy co-ordination as it now feels that countries are free to pursue their own economic policies regardless of what has been established in the Treaty. Hence, what can be regarded as a positive step towards growth oriented measures can become a serious handicap in the long term as the co-ordination of economic policies is now more difficult to attain than before.

The synergies this economic co-ordination could entail are jeopardised and that will have a negative impact on the long term growth potential of the European economy. It might be possible to overcome this scenario but only if more co-ordination is accepted by Member States (before envisaging co-ordinating with the ECB) when it comes to both fiscal and structural policies.

1.4.2- Sanctions

The system of sanctions to enforce the SGP rules has lost its credibility. Countries now have the choice of either reinforcing the sanctions mechanism in such a way as to improve its efficiency, which would have to imply making it less dependent on Council decisions, or transforming the current SGP into something that would fall under the spirit of the open method of co-ordination, in other words, exchanges of best practices and discussions at the Council level without any enforcement rules. The former would be more in line with what is the European interest, whilst the latter could satisfy many domestic demands as it would make economic policy more dependent on domestic needs without the corresponding recognition of a common European interest. A third solution would be to have a formal sanction in the treaty but one that would be softer than the present one. This would ensure that sanctions would be easier to apply and hopefully countries would try to behave according to the rules, as they would want to avoid being sanctioned not only because of the economic sanction in it, but also due to the political onus countries would incur. This will be developed in more detail later.

1.4.3- Exchange rate

Despite the collapse of the SGP, the Euro continues to appreciate in relation to the USD. However, it should be remembered that the current Euro appreciation is mostly due to a weakness of the USD caused by a serious of events (more concretely a continuous increase in the US budget deficit). Financial markets, nevertheless, became aware that Member States were not capable of defending the mechanisms they had themselves created to protect the sustainability of the common currency, and in different circumstances the continuous appreciation of the Euro would not have been as likely as it proved to be.

1.4.4- Debt servicing

This solution might pose more difficulties to some small Member States. Indeed, one of the benefits of joining a common currency such as the Euro to small Member States is the opportunity to increase their external credibility. However, if the Members of the club cannot guarantee the credibility of the common currency, then small Member States will most likely face an increase in their rating, that is to say, the risk premium they incur if they wish to borrow. Hence, small Member States might possibly face more difficulties to borrow from financial markets and therefore will have a further constraint in case, for example, they wish to borrow to finance growth oriented measures in line with the Lisbon strategy.

1.4.5- Economic governance

The actual suspension of a treaty decision might put the whole institutional framework of economic governance into question as the European Commission was unable to act as guardian of the Treaty. The current system is based on a Council ruling and it proved to be ineffective.

1.5- The impact of population ageing in Europe and its relevance for public finances

Population ageing is a serious problem Europe will have to face in the years to come. The objective of this section is not to deeply discuss the topic but merely to highlight the main challenges this issue implies as well as to give a brief assessment of how this can affect European economic policy.

As can be seen on the graphs presented in annex 1, the situation is different, between, on the one hand, Europe and Japan, and on the other hand, the USA and China. Regarding the latter, we can see an increase in both the total population and the share of men and women over 60. However, in the former there is a decrease in total population and an increase in the share of men and women over 60. This means that the share of men and women over 60 will be significantly higher in Europe than it will be in the USA. Indeed, various studies point to the excessive burden that will be imposed on public spending from 2015 onwards, simply due to population ageing. These studies point to an increase of between 4%-8% in public spending just to finance pensions. According to a recent UN study, developed countries are likely to lose 15 million inhabitants, a situation which will naturally imply a stronger effort by the State to cope with this pressure. As seen, the term “developed countries” refers mainly to Europe. This clearly implies different challenges for US and European fiscal policy. In Europe, spending for pensions is likely to be higher than in the case of the USA as there will be a lower active population and more people in retirement in Europe than in the USA. This has some straightforward implications:

1. Less tax revenues as well as social security contributions which implies spending cuts, if the budget is to be kept in balance;
2. A necessary increase in pensions spending;
3. An increase in health care costs as a rise in the share of the oldest population segment predictably implies a rise in health care expenditure.

Hence, the future situation in Europe will be that of less tax revenues (unless income and corporate taxes increase which is something that goes against the desires of national Governments and is also contrary to the European Employment Strategy due to its negative effect on growth) and less social security contributions combined with a necessary increase in spending just to finance pensions. The pension reforms in all European countries are also of crucial importance for the future and have started to be made, for example in Portugal, France, and Austria. Therefore, it is essential that countries pursue sound fiscal and budgetary policies in the years to come which imply expansionary policies during economic downturns and restrictive polices during an economic boom period. Thus, controlling spending[8] should be regarded as something essential. If not, countries will be faced with no other option but tax rises to cope with the extra expenditure that will be needed just to finance pensions.

[8] The term “controlling spending” is not used as a synonym for spending caps but rather as a better definition of what should be accounted as necessary public spending. This, along with the golden rule of public finances, will be developed in a different section.

1.6- The sanctions mechanism

The sanctions mechanism has always been subject to criticisms. Indeed, several experts pointed out from the very beginning how difficult it would be to sanction any possible deviant behaviour by a Member State, due to the fact that sanctions needed to be approved by the ECOFIN council in order to be imposed. The reason was that it is very unlikely that Member States will sanction their peers when they know they might face a similar situation in the future. Moreover, sanctioning another country entails high political costs that individual countries have no interest in incurring. Therefore, credible sanctions could only be applied effectively by a supranational institution and in the current EU framework the only institution with such a profile is the European Commission. The most recent example of violation of the stability and growth pact rules is the case of France and Germany. France, for example, and despite being above the defined threshold, has persistently insisted on continuing with its current policy. This implies not lowering the deficit to the level defined and agreed in Amsterdam in 1998 and even assuming a confrontational strategy with other Member States (namely Austria and the Netherlands) and the European Commission. However, the outcome of this strategy seems to have paid off as the European Commission ended up by conceding an extra year to both countries, thereby adopting a more flexible approach while at the same time trying to respect the spirit of the pact. That solution was still not accepted by both countries and the sanctions mechanism was eventually not applied, as the Council eventually did not approve the Commission's recommendation.

All these events just prove how inefficient and arbitrary the current system is: on the one hand, the sanctions mechanism which exists to ensure the credibility of the rules of the stability and growth pact is clearly questioned; on the other hand, it is clear that different behaviours exist, depending on the country that is breaking the rule. Indeed, in the case of Portugal the Commission urged Portugal to undertake the necessary steps to bring its deficit down, which Portugal did by bringing it down from 4.1 to 2.8% of GDP in one year, namely by recurring to a set of one off measures (e.g. introduction of tolls on some roads to create extra revenues). However, in the case of France, which clearly is a country that not only is more relevant economically for the Eurozone as a whole, but also has more bargaining power than a small country like Portugal, the European Commission was more flexible although it was still defeated.

This poses clearly more serious problems to the current framework of economic policy co-ordination rather than merely the fact of some countries having surpassed the deficit threshold: now it not only is clear that the current fiscal policy rules might be inefficient in an economic perspective, but it has also become obvious that the whole decision mechanism that has been defined in an annex to the treaty and agreed by all Member States is put into question. Indeed, at the present moment, the credibility of the stability and growth pact is seriously damaged. Another proof is the current statement of the Portuguese Minister of Finance who argued that bringing the deficit down was an economic objective and not simply something defined by Brussels, as even if Portugal would surpass the deficit limit, most probably no sanctions would ever occur. In other words, countries do not seriously regard the sanctions mechanism (as defined by the stability and growth pact) as credible and, consequently, have no efficient binding rule to co-ordinate their economic policies.

Hence, an improved sanctions system is necessary to improve the efficiency of economic policy co-ordination in the Eurozone.

1.7- <u>The deficit situation of the former candidate countries</u>

Table 1- Net Borrowing (-) or lending (+) in the Candidate Countries

Year/Country	Cyprus	CZ	Estonia	Latvia	HU	Lithuania	Malta	PL	SLK	SLO	BL	RO
1992	…	-2.5	…	-0.5	…	…	…	-7.1	…	…	…	…
1993	…	-23.4	10.2	2.4	…	-0.8	…	-4.5	-31.2	…	…	…
1994	…	-3.4	4.6	-1.5	…	-0.9	…	5.8	-6.1	…	…	…
1995	…	-12.3	-0.1	-2.3	…	-2	…	-2.5	-0.9	…	…	…
1996	…	-1.9	-2.3	-0.5	…	-3.7	…	-2.9	-7.4	…	…	…
1997	…	-2.4	1.5	1.6	…	-1.2	…	-2.8	-6.2	…	…	…
1998	…	-4.7	-0.9	-0.7	…	-3	…	-2.3	-5.2	-2.2		
1999	-4.4	-3.7	-2.8	-5.3	-5.6	-5.7	-8.2	-2	-7.8	-2.1	0.4	-4.5
2000	-3.1	-4	-0.3	-2.7	-3	-2.3	-7	-2.5	-13.5	-3.1	-0.5	-4.6
2001	-3	-5.8	0.3	-1.6	-4.2	-2.2	-6.8	-3.1	-7.2	-1.3	0.2	-3.3
2002	-3.5	-7.1	0.9	-3	-9.2	-1.7	-6.2	-3.9	-7.2	-2.3	-0.7	-2.6
2003	-5.2	-8	0	-2.7	-5.4	-2.6	-7.6	-4.3	-5.1	-2.2	0	-2.7
2004	-3.7	-6.3	-0.4	-2.7	-4.4	-3.1	-5.8	-5.9	-4	-1.8	-0.7	-3
2005	-2.9	-5.2	0.4	-2	-3.6	-2.7	-4.1	-4.9	3.4	-1.7	-1	-3

Source: European Economy, November 2003 data, European Commission 2003

As can be seen from the above table, most of the future EU Member States now have a deficit which is higher than the 3% threshold imposed by the treaty. However, more relevant than this is the fact that, at least 5 of them (Czech Republic, Hungary, Malta, Poland and Slovakia) do not seem to be willing to come under the limit in 2005. The other countries (with the exceptions of Cyprus, Lithuania and Romania) already have an experience of deficits under the 3% limit and indeed enjoyed lower deficits even before the formal adhesion process started. This is the case of Estonia, Latvia, Slovenia and Bulgaria. Therefore, in practical terms and simply by looking at economic data, the SGP has only been successful in acting as a persuasion factor in 3 cases (Cyprus, Lithuania and Romania although the latter is happy just by reaching the limit in 2005).

Therefore, the SGP does not seem to be regarded as something essential by the countries that will soon join the EU and that in most cases wish to join the common currency as soon as possible. This should not be surprising: the SGP and the limits it imposes might not be adequate in the case of the future Member States, given that most of their economies are and will be growing at a faster pace than the EU average. Public investment is essential in this phase of development as most of these countries still lack basic infrastructures.

Nonetheless, the non willingness to comply with the SGP rules by countries that wish to join the Euro area, the SGP being one of the most important pillars of the Euro system, should raise some questions, namely as to whether the current SGP is flexible enough to accommodate the divergence in economic structures that currently exists and that will be significantly aggravated.

II -- SOME POSSIBLE SOLUTIONS

2.1- Some proposals to reform the stability and growth pact

As mentioned before, the Commission has already taken an important step by taking into account the structural deficit rather than the nominal one. This takes into account the effects of the business cycle. The reform of the SGP should include other variables, such as a better definition of public spending, namely a distinction between investment expenditure, current expenditure and revenues, national debt levels, the use of anti-cyclical policies and clear binding rules (strong sanctions). Moreover, the pact ought to be an active economic policy co-ordination mechanism and ought to move alongside the Lisbon objectives. I shall now refer to each of these points separately:

- The new SGP should be focussed on a compromise between short and long run objectives. That would imply controlling spending and continuing to pay close attention to the deficit levels across the European countries, besides focusing attentively on the debt level in the long run. There must be a binding rule similar to the one existent in the deficit criteria but concerning the debt levels which would also have to be enforced. Namely, countries with high debt values should commit themselves to lower their debt at a constant pace every year so as to attain a sustainable value over the long run. Also, if the European economy faces an unexpected slowdown of economic activity (and not only a serious recession), there should be a more flexible approach to the rules allowing countries to follow investment policies (not discretionary tax cuts), especially if deficits are under the limit. A compromise between the short term and the long term objectives seems therefore essential.

- The new stability pact should clearly state that pro-cyclical policies should not be pursued and in case they are they should always be discussed in advance and other countries should be informed. That could include tax cuts in economic boom periods without the respective cuts in spending. The Commission should be given the formal power of starting actions against a country if it would find evidence that a particular country was undertaking policies that would violate the spirit of the new pact, namely pro-cyclical policies. A question that may rise is whether the Commission should take action even when the whole EMU area is not under threat due to the policy of a member state. This question was posed when the Commission started the procedures against Ireland that the Council eventually adopted. Some claimed that the Council should not have adopted such a procedure on the grounds that stability in the EMU would not be affected as the Irish economy represented only a minor part of it. Nonetheless, if it is true that initiating such a procedure should be carefully pondered (as it can lead to adverse and negative reactions, particularly on the part of public opinion in the country in question), countries participating in a monetary union should be treated equally.

- The definition of a pro-cyclical policy is of major importance. Here, again, an increase in expenditure in R&D during an economic boom, for example, should not be regarded as a pro-cyclical measure but should be assessed as to whether it is important for growth. On the contrary, discretionary tax cuts without informing other countries and without proper economic co-ordination should be avoided. In this case, the definition of pro-cyclical policies would be endorsed by the Council following a proposal from the European Commission.

- The new SGP should have clear and binding rules governing the deficit value, the use of pro-cyclical policies and the debt value. Those are of extreme importance for two main reasons: firstly because they are more likely to bind the actions of members states (if enforcement is credible) and secondly because it improves the transparency of economic policy and therefore its credibility. The success of the Maastricht convergence criteria illustrates this point clearly, namely by the success it had on bringing down interest rates, budget deficits and debt levels in the 1990's. The sanction in that case was not financial but was economic and political: not being part of the EMU. Moreover, member states should be aware that those rules would be enforced in case they would be breached. This implies that leaving the power of deciding to impose sanctions or not against the non-virtuous countries to the Council in the way it is done currently, may not be adequate. Ideally, the Commission would make to the Council either an early warning or an excessive deficit proposal, if it wished to do so. Therefore, the Commission proposal would automatically come into force if it weren't rejected by the Council.

- The current SGP does not take into account the reasons that lead to a given deficit. A country that has a deficit caused by higher investment expenditure, let us say, due to increased investment in infrastructures and/or R&D, will under the current framework, be regarded in the same way as a country that breached the threshold due to a rise in current expenditure and/or due to the use of pro-cyclical policies during an economic boom without the respective cuts in expenditure. Therefore, it is essential to distinguish “productive” from “non productive” spending. If European countries wish to stick to the Lisbon agenda (and the sustainable development strategy) and so make Europe the most dynamic and knowledge based economy by 2010, countries will need to make the necessary economic reforms and to invest more resources into areas such as research and development, just to give an example. It can be argued that private investment will play the main role in this process. Nonetheless, it is dubious to believe that the state will not have to make a greater effort to attain the Lisbon objectives. Therefore, that could lead to an increase in investment expenditure and accordingly to a rise in the budget deficit, contributing to a further deterioration of the public finances, in case the current definition of the stability and growth pact prevails. Hence, the new SGP should identify clearly what are the expenditure types counting towards the final deficit value and at the same time give the necessary room for manoeuvre for member states to pursue investment and growth oriented policies. Investment in R&D, education, environment and crucial infrastructures should be dealt with separately. One possible way to do this could be by introducing the golden rule of public finances.

2.2- The Golden Rule of Public Finances and the SGP

Box - What is the golden rule of public finances?

Literally, the golden rule of public finances implies that the government can only borrow to finance investment and not current expenditure. The golden rule of public finances is applied in some countries, namely in Great Britain, in the States of the USA (to the level of State government and not of Federal Government), in some states of Australia and of New Zealand. The Golden Rule is an old topic in economic theory and it has always had supporters and opponents. Supporters usually argue that it prevents underinvestment from occurring. In other words, by allowing the State to borrow to fund public capital formation, we are distinguishing between public capital formation (the so called "good deficit") from investment to finance public consumption ("bad deficit"). Its opponents however criticise the golden rule because it might foster overinvestment in the sense that investment decisions are usually taken by politicians that are only concerned with the electoral cycle and often do not take into account the productivity effects of the investment but rather its short term impact on voters. Accordingly, politicians are tempted to account all investment as public capital formation investment and to have a rather expansionist use of fiscal policy, which ultimately could be damaging in the case of the EMU, as it would create inflation and a rise of interest rates, which would lower investment, employment and consequently economic growth.

As mentioned above, the stability and growth pact prescribes the attainment of a balanced budget, that is to say, revenues equal to spending. A balanced budget however fails to acknowledge the fact that deficits are not always bad, that is to say, a deficit caused by the Government borrowing to finance public consumption is different from a deficit caused by the government borrowing to finance investments, in line with what has for example been defined in Lisbon. An alternative to the balanced budget rule is the golden rule of public finances which enables the Government to borrow to finance capital formation expenditure. However, the application of the golden rule is not straightforward: firstly, governments might be tempted to include more than desirable expenditure as capital formation spending (desirable defined as the economic and social optimum to the society). This would lead to a very expansionist fiscal policy which could ultimately produce two adverse effects: on the one hand, it could create inflation which would imply a probable rise in interest rates; and on the other hand, it could have negative externalities as it could affect the whole of EMU as a shock in fiscal policy in one country can affect the other countries. Secondly, there is evidence from some studies that investment decisions taken by Governments are not always consistent with an economic rationale. Indeed, the criteria to evaluate an investment should be its rate of return and that is not often the case[9]. Naturally, it can be argued that social investments carried out by the State do not necessarily need to be economically profitable. Investments in childcare infrastructures with the aim of increasing women's participation in the labour market, financial incentives to companies to hire disabled people, among many others, are investments that are part of the employment guidelines that make up the European employment strategy which requires investments that are difficult to quantify in the form of expected rates of return. This however does not mean that such criteria should not be taken into account with the aim of preventing over investment and, consequently, a waste of resources. Finally, some see the Golden rule as a handicap to reach the objective of consolidating public finances which is essential if we are to face the future problems that will be caused by the demographic crisis Europe will be facing.

Given what has been argued so far, the Golden rule of public finances is regarded by some as dangerous because it is difficult to put into practice and can lead to a higher than desirable increase in public spending, which could pose problems to the whole of the EMU namely by the likely increase in interest rates it would imply.

However and despite being difficult to apply, there is a rationale to put into practice a rule taking its inspiration from the golden rule of public finances. The main reason is that it is far from true that deficits, as long as they are small and controlled, damage the economy. A deficit which is caused by an increase in investment in line with has been agreed in Lisbon will tend to foster economic growth, can create jobs and therefore lower the unemployment rate. This leads to an increase in tax revenues thereby contributing to offset the initial deficit. Moreover, public investment can also lead to an increase in private investment. The nature of the deficit is therefore of crucial importance and should be well defined and explicit, if a golden rule is set as part of the fiscal policy strategy.

[9] Cadot et al. (1999) found that in France public capital formation in a region is higher when the regional and central Governments have the same ruling political party. Kemmerling and Stephan (2000) found the same regarding grants conceded by the German Landers to German cities.

Hence and for the golden rule to be effective, some measures would have to be taken:

- The first and most important thing that would need to be done is to define the type of investments which could be included in the golden rule, in other words, the investments which would be exempted from deficit calculations. One possibility could be to apply the Golden Rule of public finances to investments that would be in line with the Lisbon strategy. Naturally, this can lead to the opening of a Pandora's box whereby some will be claiming that investments in defence to modernize the European military capacity are essential, while others will argue that investments in health care are crucial, especially given the possible impact the future demographic crisis will have. However, the need to define clearly and very precisely what can be accounted as capital formation investment is imperative; otherwise, Europe might face a crisis of overinvestment and fiscal discipline, which is important for the smooth functioning of the EMU. Investments in defence and health care are indeed important and are in line with important objectives and needs of the EU. Nevertheless, the only strategy Europe has to foster economic growth is the Lisbon strategy which was endorsed by all Member States. It sets clear targets and objectives. Neither in defence nor in other sectors is that presently the case. In defence, for example, many wish the EU reinforced its military capabilities but this is far from being consensual and, hence, it would be dangerous to start applying a common strategy to investments, which only some regard as a priority. Moreover, if the golden rule is to be effective, it is essential to limit its scope: if everything starts to be accounted as public capital formation, then the policy will be less transparent and less effective. It will also increase the temptation of politicians to include investments that might be of dubious effectiveness. It is thus important to set the limits for the implementation of such a rule and those limits should be kept within the Lisbon objectives.

- Therefore, it is of crucial importance to define clearly and transparently the types of expenditure that can be exempted from the deficit. The criteria, as mentioned before, should be as simple as possible and should be based on what the European interest is, in other words, projects that are within the spirit of Lisbon should be exempted from deficit calculations. However, they should be decided in advance and keep to a long term strategy. For that to be the case, the European Commission should be invited to propose a list of projects that have a European dimension (not necessarily cross border projects but projects that can create positive synergies between Member States and projects that can set an example as best practice because of their innovative character). The Commission should then elaborate a list and submit it to the Council which would be responsible for approving it. This could be inspired by the recent growth initiative but would be enlarged to other policy areas, preferably within the Lisbon strategy.

- All projects in the spirit of the Golden Rule would have to be preceded by independent assessments to ascertain that they do not respond to electoral cycle reasons and that they are in the common European interest, they would also have to carefully evaluate the future rates of return the project would imply. Therefore, projects would be tabled by Member States individually or by more than one Member State (if that were to be the case), but would have to be assessed by an independent study group created by the European Commission with the responsibility of evaluating the “European” interest of the projects. Such a group would not take the final decision as to whether the project should be incorporated in the list, but would issue a non binding opinion (and would make it public) which would then be sent to the European Commission which ultimately would decide whether the project should be included or not on the list of projects to be proposed to the Council. In this way, the risks of overinvestment would be minimized as there would be the guarantee that projects would make economic sense.

2.3- The link between sanctions and credibility

The objective of a system of sanctions within the framework of the stability and growth pact was to ensure countries did not go above the agreed deficit threshold which was defined as 3% of GDP. However, this system, as discussed above, has been shown to be ineffective for two main reasons: firstly, it was not capable of deterring countries from going above the 3% ceiling and secondly because, once this occurred, sanctions proved to be impossible to apply.

This apparent lack of credibility raises the issue of whether sanctions are indeed necessary or desirable. Some argue they are not and point to the above mentioned scenario, that is to say, no country would ever pay a fine for not complying with budgetary rules (Begg, 2003). In that case, the most efficient solution would be reached at Council level, in a solution somehow inspired by the open method of co-ordination which would allow for an exchange of best practices and hopefully lead to a better policy outcome.

However, the opposite can also be argued: in other words, if strong co-ordination (in this case sanctions) did not ensure the required co-ordination why would a weak form of co-ordination be more efficient[10]? Moreover, within the current framework and even if the Commission plays an important part, the bulk of responsibility still lies with the Council. The Commission only has the power of recommendation, which necessarily implies hard negotiations with all Member States with a view to have its recommendation approved by the Council. Hence, if within the current framework the Council was unable to ensure the proper functioning of what had been agreed, what are the new facts that would make a weaker form of co-ordination work? Indeed, the open method of co-ordination is not the solution to the problems facing the stability and growth pact. It is more efficient in areas where co-ordination is traditionally more difficult to obtain, such as education, culture, pensions, etc. In economics the response must be of another nature, especially given that we do have a monetary union, whereby countries have already given up their sovereignty in monetary policy. This monetary union must be accompanied by more co-ordination of economic policies in a form that needs to go beyond an exchange of best practices and of benchmarking but that unfortunately, has not been the case, in the sense that we are still in presence of twelve different fiscal policies and the fact that the minimum co-ordination rules that do exist have been broken. Countries have persistently pursued their own economic polices without informing and discussing them with their peers. Ultimately, this leads to less synergy in economic policies and to a lower growth potential than in the case where economic policies would be co-ordinated.

Another suggestion that has been put forward is the creation of a different sanctions mechanism meaning the creation of a different type of sanction. This suggestion recognises that co-operation between players (in this case, Member States) does require some form of enforcement but argues that the existence of financial sanctions is counter-productive, since it is not credible. Consequently, one of the ideas that were brought to the debate is the creation of a softer sanction, for example, the imposition of a progressive fine that would take the form of a percentage of GDP that players (Member States) would have to pay on top of their debt

[10] Obviously, discussions between peers still occur in the presence of a strong co-ordination mechanism. Indeed, it can be argued that strong co-ordination (rules) acts in a way to force discussions, as countries are aware that if they do not effectively talk and co-ordinate their actions to achieve a better policy outcome, they might be sanctioned.

service. This idea does have the merit of, in principle, making sanctions more credible, as they would be more easily applied by comparison to the currently existent sanctions that require a non interest bearing deposit by the sanctioned Member State. However, as previously mentioned, the objective of sanctions is not to apply them but, instead, to have something that would deter misbehaviour by one or more players. Having softer sanctions might provide an incentive for misconduct as countries know the price they will have to pay for not respecting the rules is low. Therefore, sanctions need to be strong if they are to be effective in their deterrence role. By having softer sanctions, we would not be preventing misbehaviour from taking place, on the contrary, we could face the risk of inciting it, since countries would know that the fine they would incur would be minimal, especially when compared to possible gains from taking measures that would go against the spirit of the SGP, which could imply a deficit rising above the limit. Let us take the example of a player who decides to lower taxes one year before elections. The impact of that tax decline, without the corresponding cut in spending, would initially be a rise in the deficit. A Government that wishes to be re-elected could prefer incurring a penalty imposed by their peers rather than losing the elections, especially if the penalty is soft. It is also argued that sanctions would not be only economic, but also political. In other words, the political cost of not abiding by the rules is high for the government and that government will try to avoid it. However, the type of sanction is directly linked to the political cost: politically the cost of not respecting a rule gets higher when the financial cost of not respecting that rule is also higher. There is, indeed, a direct link. With a softer sanction, meaning one whereby the economic cost of not respecting rules is low, the political cost incurred by not respecting them is also low. Clearly, it is more politically significant for a country to pay a high financial fine as a consequence of infringing rules than to pay interest on top of their debt, which is in itself almost insignificant economically.

Therefore, for a more efficient economic policy co-ordination and for an efficient stability and growth pact, sanctions stand as an important ingredient. Sanctions are the mechanism that ensures certain targets are attained. Besides, these sanctions need to be strong enough to be persuasive. A softer sanction might initially look more appealing as it would be more easily applied but might provoke the opposite effect, that is to say, inciting misbehaviour rather than preventing it.

The current sanctions mechanism lacks credibility but that credibility could be improved in two ways: 1) by improving the decision process that leads to their implementation and 2) by improving economic policy co-ordination which is the only possible way to make countries co-operate with each other and thereby reaching a higher policy outcome which would diminish the need for the existence of sanctions.

A third problem encountered by the current sanctions mechanism, essential to a well functioning stability and growth pact, is linked to one of the main shortcomings of the stability and growth pact as a whole: it only refers to a percentage value. In other words, a country that has made an effort to invest in R&D will be judged in the same way as a country that undertook a tax cut just before an election, which is not part of a tax reform. As has been argued before, spending in line with the Lisbon goals should be dealt with separately from tax cuts that have electoral motivations. This should be linked to the way sanctions work: a country that surpasses the 3% limit because it has strongly invested in R&D should be treated differently from a country that has gone above the ceiling due to a rise in current expenditure. Another important point that should be taken into account is that structural reforms have a financial cost. An example is labour market reforms and the so often demanded more flexibility in the labour market. As can be seen from the table in annex 2 labour market reform can be ensured mostly by reducing employment protection, which is far greater in Europe than in the USA.

However, as pointed out by Beetsma and Debrun[11], these reforms are often associated with higher short run costs even if they could have a positive impact in the long run (e. g., a decrease in unemployment levels). As can be seen from the table, employment protection is the most significant difference between the USA and Europe. If structural labour market reforms would go in the direction of lowering it, then the likely short term impact would be an increase in the unemployment figure in the short run, which in turn would have an impact in the demand for unemployment subsidies and, hence, aggravate the deficit level. Therefore, the short run costs, namely the impact some structural reforms can have on the deficit in the short run, cannot be neglected and its costs need to be clearly assessed before a decision on sanctioning a country is taken. Indeed, with the current mechanism, and all other things being equal, a country that is pursuing structural reforms in line with the Lisbon objectives and with

[11] Refers to the same working paper as above.

the broad economic policy guidelines, might be sanctioned under the spirit of the current stability and growth pact, since the cost incurred when undertaking those reforms (and the cost of their consequences) might be high, at least in the short run. This is another example of the existing lack of co-ordination not only between Member States but also between the economic policy co-ordination mechanisms we currently have. Ultimately, we cannot have a co-ordination mechanism which pledges structural reforms and another which might sanction a country due to the costs that country has incurred when carrying out those reforms. This does not make the system a credible one.

Credibility is a crucial aspect. If Member States feel that their peers will never sanction their actions, then the whole system is put into question. Any sanctions mechanism can only be effective if it is thought to be enforceable, and in order to be so, participants need to be sure it can be implemented. Therefore, credibility is a very important and decisive concept in this mechanism. Sanctions can only work if they are credible and one way to make them more credible could be to endorse the power of proposal to the European Commission. It can be argued that it would not solve the problem, as it would still be up to the Council to vote on whether the proposal would actually be endorsed. But rejecting the Commission proposal would surely make the Council's decision more politically binding.

Hence, improving the current sanctions mechanism does not imply the creation of a softer sanction, but rather making the existing one more credible and therefore more enforceable, which means the reversal of the present decision making procedure, whereby the Council adopts the recommendation by QMV, by moving to a system where the Council is able to reject the Commission's proposal by QMV.

2.4- <u>The sanctions system and the golden rule of public finance</u>

A second feature that would improve the current mechanism would be the introduction of the Golden rule of public finances for four main reasons:

1. It would mean countries would be sanctioned when they would surpass the deficit limit as long as that would not be due to an increase in investment expenditure[12];
2. It would make the stability and growth pact more compatible with the Lisbon objectives and also with the broad economic policy guidelines;
3. It would allow for a transparent quantification of the cost countries actually incur when performing structural reforms or measures to foster the EU's growth potential;
4. It would force countries to make further efforts to control their non-investment related expenditure which might not be beneficial to economic growth and which can jeopardise the future of important social policies as well as of the pension system.

Therefore, the golden rule of public finances would imply a country would be sanctioned because it failed to cut non productive spending and not for investing along the lines of the Lisbon strategy. This would be likely to increase the credibility of the mechanism.

Finally countries would be subject to sanctions, if their public debt value would not be reduced at a constant yearly pace. Countries would be requested to properly estimate the costs of their structural reforms, as well as the costs of the implications of the reforms (if any) when presenting their stability and growth programmes to the European Commission.

One final point which deserves attention when discussing sanctions is whether imposing sanctions on a country is credible in the eyes of public opinion, having, as its basis a mechanism which some would argue is not democratic. In other words, are the current stability and growth pact and the sanctions it entails democratic?

[12] Investment expenditure that would have to match the criteria previously defined and agreed by Member States.

2.5- Democratic legitimacy and the SGP

The stability and growth pact has also been continuously criticized for not being democratic in the sense that it does not reflect the desires of the population that legitimately expect economic growth and full employment to be the central economic policy objectives. Moreover, it is argued, the current system is nothing more than a pact decided by Heads of State, whereby National Parliaments and even the European Parliament are left aside and therefore, the argument follows, the desires and the expectations of citizens are not taken into account.

Indeed, it cannot be denied that the current system derives mainly from an agreement that has been reached by the Heads of State in a compromise which is far from being efficient (Germany decided it wanted a pact to protect the Euro against some possible erroneous policy decisions that would be taken by historically high spending countries whilst France decided the nominal reference values that should be adopted and also included the word growth without trying to provide tools to achieve that same objective). Clearly, this is far from being efficient, credible and desirable not only from the democratic point of view, but also from the economic one.

Notwithstanding, the need to have fiscal rules to protect the Euro was already mentioned in the TEU, namely in its article number 104 C. This article is clear in various aspects, namely 1) Member States should avoid excessive deficits, 2) the institutional procedure to be followed if a Member States does not comply with the rules and 3) the consequences a Member State would face, in case it did not abide by what had been agreed. Moreover, in protocol 5 which is annexed to the TEU the nominal values for what is to be regarded as excessive deficit and public debt are explicit. Regarding its point 3, the TEU explicitly states the consequences a Member State might incur, if it did not comply with the rules and clearly mentions the possibility of a Member State having to make a non-interest bearing deposit as well as the possibility of fines. Hence, the TEU made reference to the sanctions mechanism that is currently in place. Later, this mechanism was further clarified and the wording changed from "an appropriate amount" of non interest bearing deposit/fines to fixing exact values for both types of sanctions. Therefore the essence of what is now regarded as a non-democratic pact was already stated in the TEU, which was ratified by all Member States, by referendum in some of them, as was the case of France. It is obviously difficult to sustain the argument that the pact is not democratic especially in the Member States that have ratified it by referendum.

In addition to this, the way in which the stability and growth pact was negotiated does not reveal many differences with the way in which other important aspects of European policy making were discussed and decided. Topics, ranging from the yearly adoption of a country's national employment plan (possibly more important to attain the full employment goal than the SGP rules) to the new CAP do not necessarily need to be accepted by both the National and the European Parliaments. The SGP is actually one more example of a decision taken at European level, possibly without the necessary democratic legitimacy, but it has neither more nor less democratic creditials to distinguish it from many other decisions taken by the Council.

Consequently, criticising the lack of democratic legitimacy of the pact should not be used as a motivation for not abiding by its rules.

Furthermore, Council Regulation 1466/97 foresees the adoption by Member States of Stability and Convergence programmes (SCP). These programmes are part of the pact and should enable Member States to undertake some mutual surveillance of their economic policies. They should contain information about the medium term budget objective, and the relevant economic assumptions which gave rise to the economic scenario/objectives stated in the programme, in order to justify whether the measures presented in the programme are enough to achieve the goals that have been set, and in order to state whether the programme facilitates closer economic policy co-ordination and finally in order to show that the economic policies envisaged by the programme are coherent with the broad economic policy guidelines. Each Stability and Convergence Programme is updated annually but should also cover the current, the preceding as well as the next three years. It is sent by Member States to both the Council and the European Commission; this body makes a recommendation about each programme to the Council which, after consulting with the Economic and Financial Committee makes an opinion about each programme and transmits it to each Member State. The Stability and Convergence programme is however prepared differently by the various Member States. In some, for example, Portugal, it is voted by the National Parliament. In others, for example, France, it is not. But this difference in procedures cannot be attributed to the Union but instead, to a domestic determination of what the National Parliament should be.

Nonetheless, in order to make the adoption of the Stability and Convergence Programmes more democratic, one step could be to have the SCP discussed by National Parliaments and to have a non binding opinion by the European Parliament on each of the programmes. The European Commission should also pursue the role of monitoring the evolution of the programmes more actively and propose to the Council any policy changes that might be needed. Each SCP already states the policy objectives and the measures to reach them for both the short and the medium run and it can play a more efficient role as a mechanism of economic policy co-ordination than it currently does, making it, thus, a more democratic one.

2.6- Co-ordination between monetary and fiscal policies[13]

The co-ordination of monetary and fiscal policies is essential if the objective is to find an optimal policy mix with the aim of increasing the economic growth potential of the EU. There are three key concepts when approaching co-ordination between monetary and fiscal policy in the EU: credibility, dialogue and trust. I shall refer to each one of these separately.

1. Credibility has two different aspects, depending on which side we derive our approach from, monetary or fiscal, each one equally important. For the monetary entity, in the EU the European Central Bank, fiscal policy should be as clear as possible, preferably neutral, when acting as part of the economic cycle so that the automatic stabilisers should act as effectively as possible and inflation can be avoided. It should also be economically oriented, in other words, as free from political and electoral motivations as possible. For fiscal entities, monetary policy should be transparent, reliable, in the sense that it should anticipate moves and accommodate fiscal policy moves.

   However, in none of the cases has such credibility been fully achieved. The EU's monetary policy has one objective, which is to avoid inflation in the Eurozone and that is indeed positive as several objectives could eventually lead to lower transparency. However, the inflation objective is not fully defined, meaning it is not clear whether the European Central Bank has an inflation floor. This implies that Member States do not fully know what the optimal inflation level for the ECB is. This has an impact on fiscal policy and on how it reacts to accommodate changes in monetary policy.

[13] Despite its crucial importance this section will not be exhaustive. For more on this please refer to Zsolt de Sousa, Hugo, "The ECB and its monetary policy", Notre Europe, June 2003.

On the other hand, monetary authorities are uncertain about the objectives of fiscal policy as they believe Governments only wish to gain elections and consequently they might use fiscal policy in a non-optimal manner. Therefore, the ECB, as a new central bank and one that enjoys a high level of independence, is reluctant to engage in a co-ordination process with fiscal authorities, since it feels Member States will try to influence monetary policy, in such a way as to satisfy domestic needs. Events such as the last ones concerning the stability and growth pact do not help to remove the doubts of central banks, as it became clear individual countries will pursue their own fiscal policies despite the existent European rules, if they believe that path is positive for their domestic economies.

However, monetary and fiscal policies are two economic policy tools. They both target different policy variables but the overall objective of economic policy still remains the same, that is to say, to reach high growth levels so as to create high levels of employment with the final aim of providing a better allocation of resources within a stable inflation environment. Being two different tools with their dual nature and instrumental value, monetary and fiscal policies have to co-ordinate their actions so as to attain a better policy mix. In order to reach that, both have to trust each other and such mutual trust can only take place when both sides engage in a serious dialogue;

2. Trust is an essential ingredient in economics, especially when monetary and fiscal policies are pursued by different authorities, one of them being fully independent from the other. To be fully independent means the ECB shall pursue the monetary policy it judges will best suit the Eurozone as a whole. However, that does not necessarily mean an absence of an informal and constructive dialogue between both sides. That trust is a continuous process built by the actions both sides take. The EMU is an original process in the sense that despite having a single monetary policy, it still has twelve different policies. Moreover, the EMU is composed of twelve Member States that still have different economic structures, a situation which will be further aggravated in the future. By having to provide one kind suits all monetary policy, individual Member States might punctually not find the existent policy to be the one best suited to their domestic needs. This is a natural consequence of a monetary union composed of countries which have different economic structures. To minimize that risk the only possible solution is for countries to engage in a true co-ordination of economic policies, a process which could be done through the Eurogroup meetings.

That process should include not only an exchange of information but concerted actions whenever possible. Those concerted actions should be taken under the new golden rule of public finances through the presentation of common projects that would force co-ordination to automatically take place. Nevertheless, there is a margin for improvement even within the current framework. Namely, countries should pursue coherent fiscal policies and should try to reach common goals. They should act according to the rules and should try to act united and to speak with one voice, at least as often as possible. That includes trying to comply with the rules that have been defined and not adopt confrontation strategies which, eventually, never bring any benefits to the Euro area as a whole. Only if more dialogue between Member States, as well as more dialogue between different institutions in each Member State, takes place, will a coherent and consistent policy be reached. At the European level, the euro group meetings should provide an efficient forum to attain more co-ordination. Member States should use that forum to reach common positions on different matters ranging from structural reforms (employment, social reforms, and pension reforms) to fiscal policy actions. A common position would be advocated by the future President of the Euro group which would discuss it with the ECB not only for the purpose of explaining the decision but also to obtain feedback from the monetary institution. That can only take place if a serious dialogue is engaged between fiscal and monetary authorities;

3. As mentioned above, the ECB has to determine the monetary stance for the whole Eurozone and that may not necessarily concur with individual needs. Hence, for a serious dialogue between fiscal and monetary authorities to take place, Member States have to co-ordinate actions among themselves and speak with only one voice. In order to reach that goal, the Euro group plays an important role, and its future President should act as a representative for the Euro area when dialoguing with the ECB and the European Commission. It should also represent the Euro abroad along with the Commissioner responsible for economic and monetary affairs.

Therefore, a possible path to achieve better co-ordination between monetary and fiscal policies should include the following aspects:

- *More dialogue between the ECB, the European Commission and Governments is crucial, if a better policy mix is to be found. However, it is difficult to advocate a better co-ordination of monetary and fiscal policies if Member States do not properly co-ordinate their economic policies first;*

- *A possible future President of the Eurogroup should hold regular meetings with the ECB with a view to better understand each other's policies. This will only be effective if the Eurogroup can act as a forum for a true co-ordination of economic policies of the Eurozone countries;*

- *The ECB is perceived as less transparent than other major central banks and that could be partly due to the current two pillar strategy as well as to the inexistence of a clear floor for inflation. This should be changed so that fiscal policy authorities can better perceive the bank's policy.*

CONCLUSIONS

The objective of this paper was to analyse whether the stability and growth pact is an efficient mechanism for economic policy co-ordination. It started with a review of the stability and growth pact, namely why it was formed, but including also the recent developments. Next, the more than predictable demographic crisis and the effects that is likely to have on fiscal policy were discussed. The European, US, Japanese and Chinese situations were compared.

The following section assessed the recent economic downturn and how that affected the stability and growth pact, as not only did it prove how difficult it was for the stability pact to act as a co-ordination mechanism when the economic situation was less favourable but as it also originated a series of comments and requests to adapt the stability pact so that it could better deal with the present situation. Following this diagnosis, its implications were discussed.

This led to a section that presented some proposals to reform the present pact; the golden rule of public finances was discussed. The sanctions mechanism was also critically analysed and some possible solutions were examined with the objective of making it more credible.

The question of whether the present pact lacks democratic legitimacy and acts as a co-ordination mechanism in the case of the future Member States was discussed. This paper ends with a discussion of the link between monetary and fiscal policies and how that can be improved.

Some of the conclusions are as follows:

- *The current stability and growth pact features economic and political imbalances that need to be dealt with;*
- *Public spending needs to be consolidated if countries wish to succeed in facing the future demographic crisis;*
- *The impact of population ageing will be mostly in Europe. Indeed the situation is more worrying in the case of Europe than it is in the USA. Consequently the future challenges for fiscal policy in Europe and in the USA are different;*

- *The current economic downturn has posed further difficulties to Member States when complying with the stability and growth pact rules. However, satisfying the demands to simply adjust the pact to the current scenario thereby making it more flexible miss the main point which is the need to undertake a serious pact reform. It would be counter productive to change rules just due to the difficulties some countries are facing and it would raise a dangerous precedent in European economic policy making;*
- *The recent events concerning the pact have however shown how volatile European economic co-ordination is, in the sense that individual Member States do not hesitate to put in jeopardy a European commitment when they believe it does not comply with their domestic priorities;*
- *This has however damaged the possibility of more co-ordination between monetary and fiscal authorities as the former now has more grounds to believe that fiscal policy might be more accommodating to political concerns rather than to economic sense which consequently raises difficulties for an Institution which is independent;*
- *The future stability and growth pact should make a distinction between investment and consumption expenditure. Investment expenditure as long as it is linked to the Lisbon strategy should be dealt with separately. This is the best possible way to achieve the Lisbon targets;*
- *Pro-cyclical policies should be carefully evaluated and subject to sanctions if they do not keep in line with European commitments in a procedure where the European Commission would be given more decision power;*
- *The new pact should also have a rule concerning debt value whereby countries would have to lower their debt ratios at a constant pace. That rule would also be subject to sanctions;*
- *The stability and growth pact should move alongside the Lisbon Strategy and not against it. Lisbon sets ambitious but clear goals for the EU and all mechanisms for economic co-ordination that are now in place should be able to foster the attainment of such goals;*
- *The Golden rule of public finances is a solution that should be seriously considered but the parameters by which it would be made effective would have to be carefully agreed. Investments made according to this rule would enhance co-operation and force co-ordination between Member States as the projects involved would be in line*

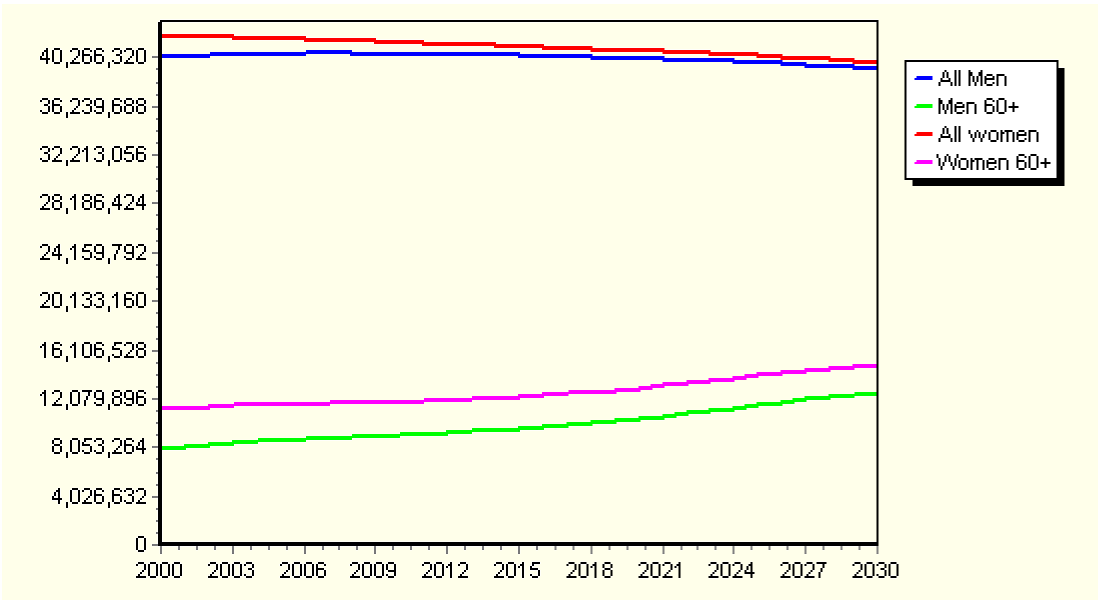
with a common EU strategy, the Lisbon Strategy. The golden rule would have to be agreed by all Member States and the European Commission;

- *It would have to imply the definition by individual Member States of projects that would qualify for investments under the golden rule, which would be submitted to the European Commission. This does not mean any loss of sovereignty on the fiscal policy side but rather a recognition that the actions a Member State takes inevitably affect the others;*
- *The sanctions mechanism has lost its credibility and needs to be strengthened. That strengthening can only be obtained through the reinforcement of the decision making procedure which inevitably implies more powers for the European Commission rather than via the softening of sanctions. However the best solution to improve the sanctions mechanism would be the improvement in the co-ordination of economic policies which would necessarily imply that Member States would be less likely to be subject to any sanctions;*
- *Countries should be subject to sanctions if they do not control and lower deficit and debt values but not if they invest in growth generating projects;*
- *The Stability and Growth Pact is not less democratic than many other EU decisions but can still be improved, most notably via the introduction of a requirement to have national stability and convergence programs discussed and when possible approved by national Parliaments as well as discussed by the European Parliament which would be required to reach an opinion on each of the programs;*
- *Policy co-ordination between fiscal and monetary authorities is essential but Member States have to previously co-ordinate their actions if they wish to find a better policy mix that involves the ECB.*

ANNEXES

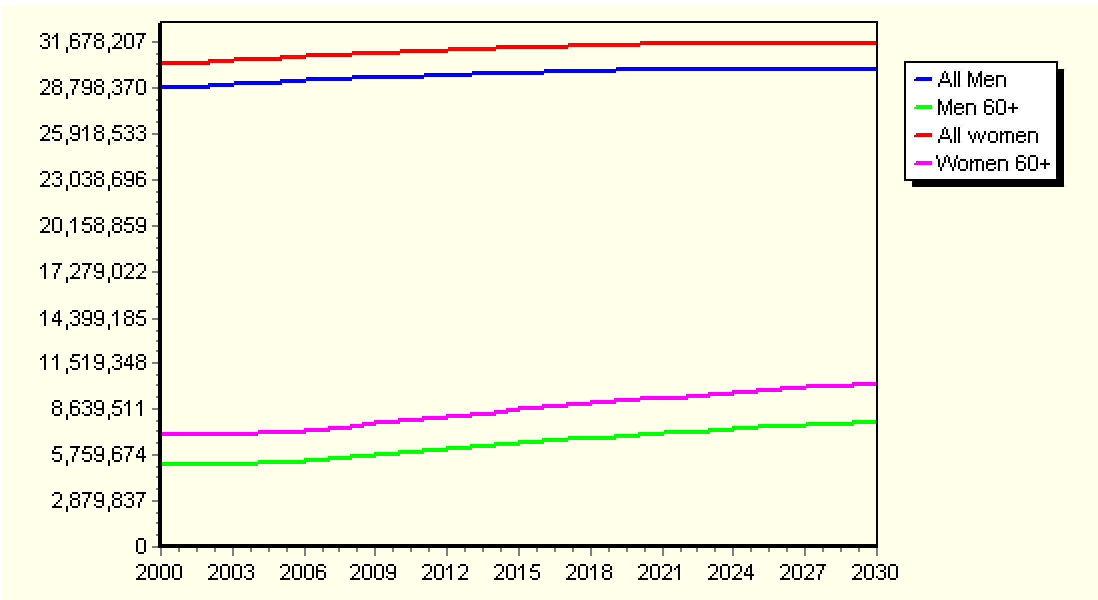
Annex 1- Population forecasts for 2000-2030 for several countries

Graph 1- Population forecasts for 2000-2030 (Germany)



Source: Policies and programmes on ageing, towards a society for all ages, UN, 1999

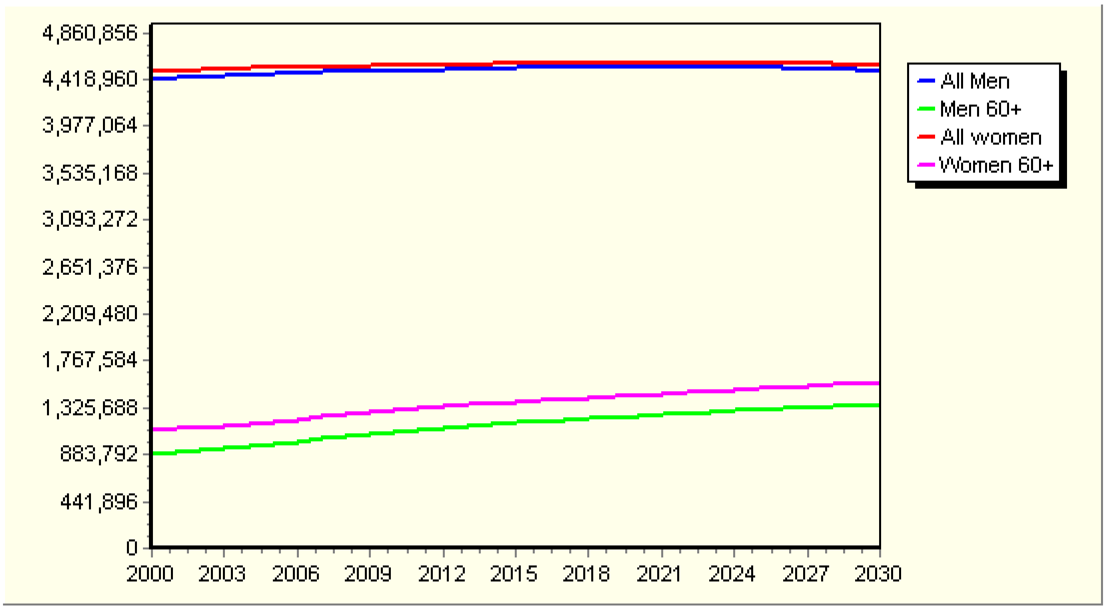
Graph 2- Population forecasts for 2000-2030 (France)



:

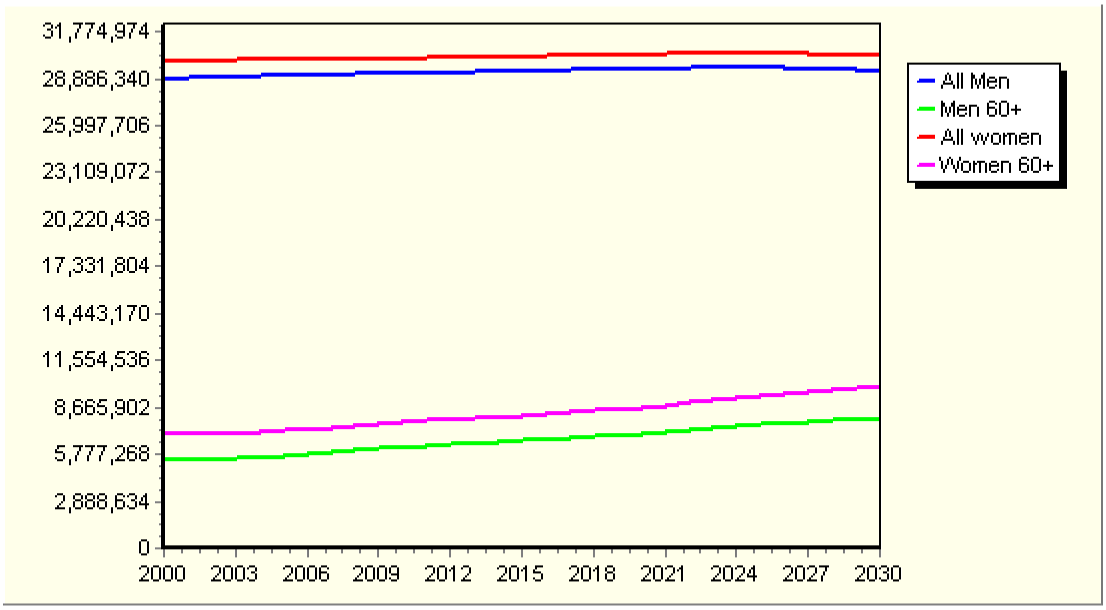
Source: Policies and programmes on ageing, towards a society for all ages, UN, 1999

Graph 3- Population forecasts for 2000-2030 (Sweden)



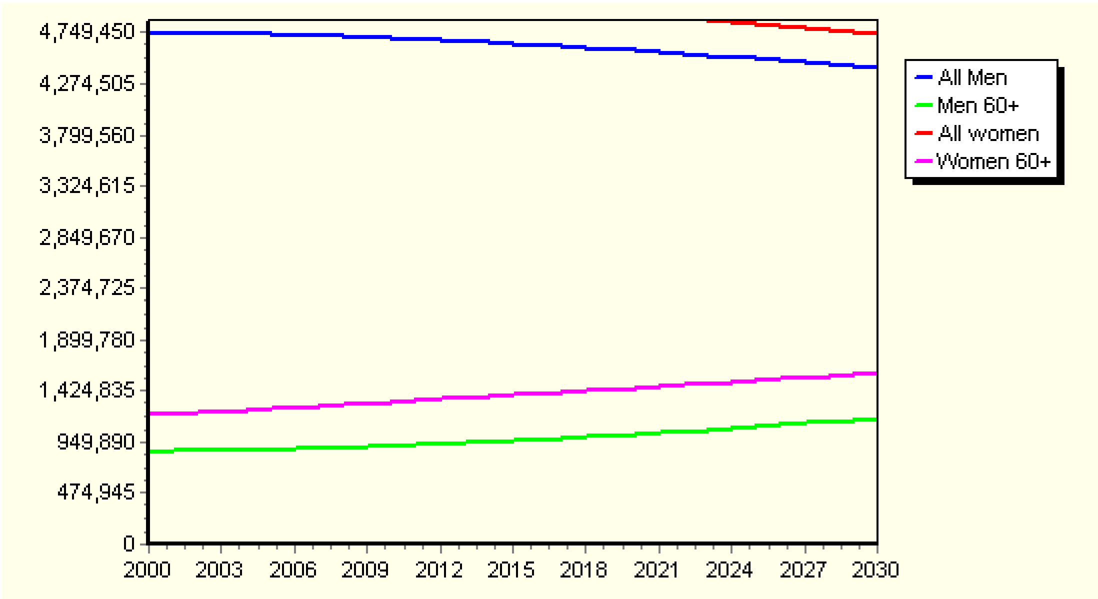
Source: Policies and programmes on ageing, towards a society for all ages, UN, 1999

Graph 4- Population forecasts for 2000-2030 (UK)



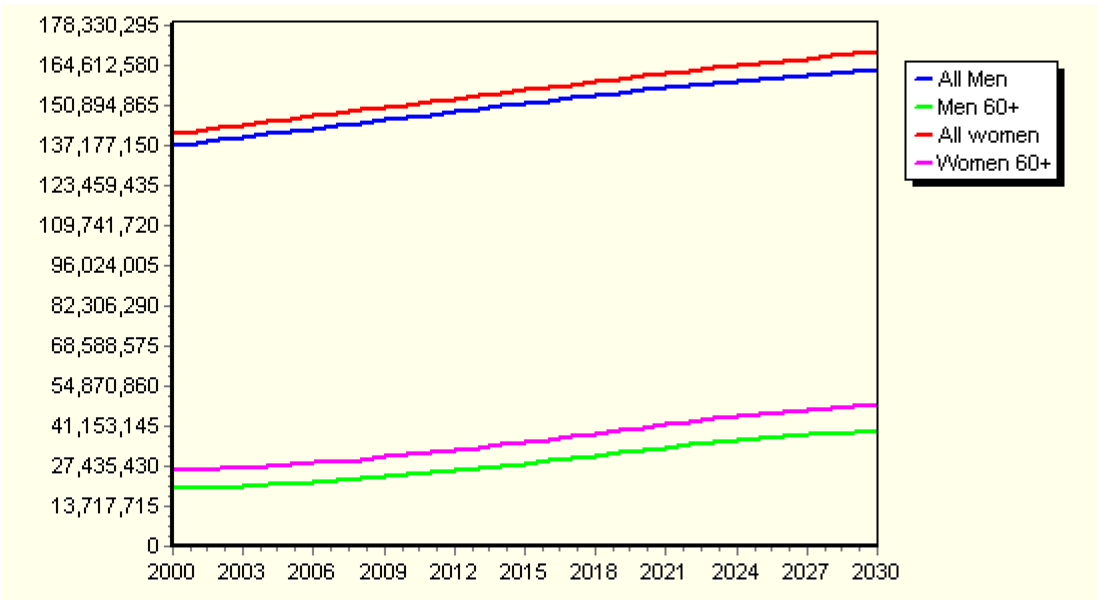
Source: Policies and programmes on ageing, towards a society for all ages, UN, 1999

Graph 5- Population forecasts for 2000-2030 (Portugal)



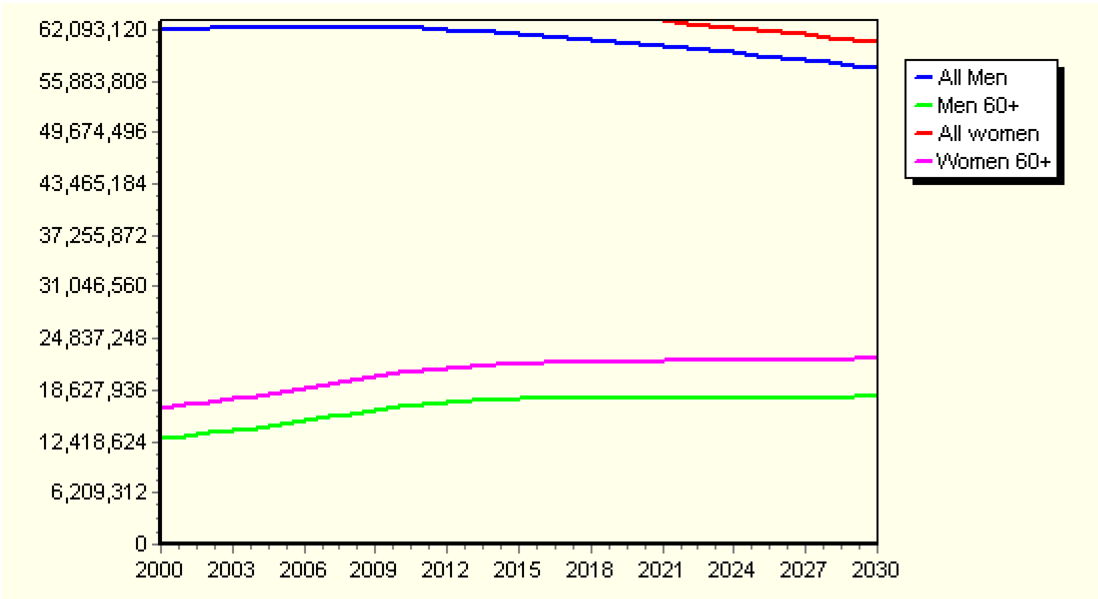
Source: Policies and programmes on ageing, towards a society for all ages, UN, 1999

Graph 6- Population forecasts for 2000-2030 (USA)



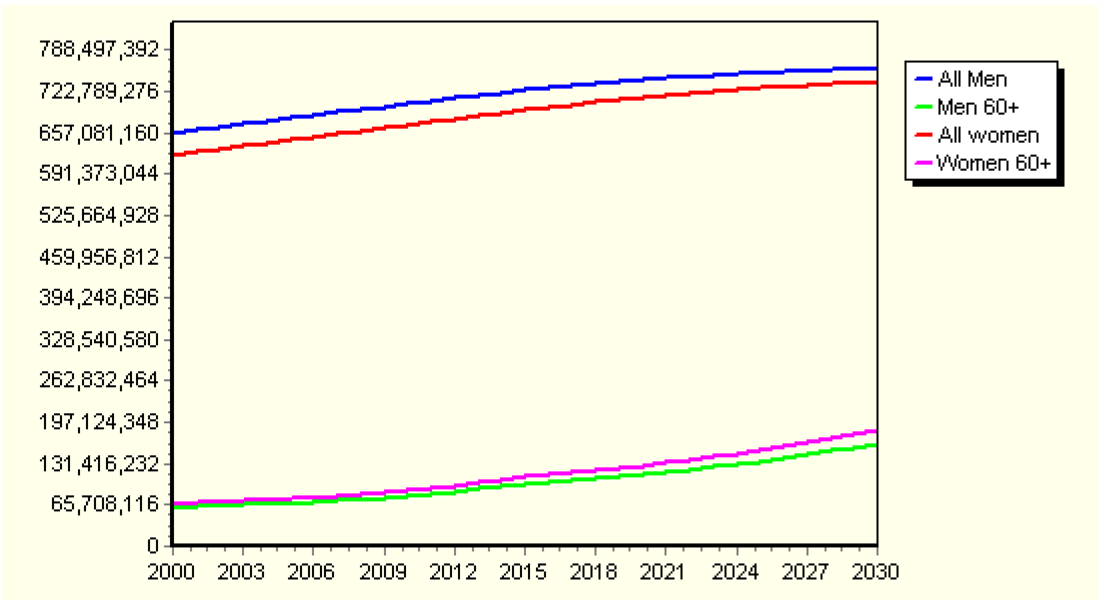
Source: Policies and programmes on ageing, towards a society for all ages, UN, 1999

Graph 7- Population forecasts for 2000-2030 (Japan)



Source: Policies and programmes on ageing, towards a society for all ages, UN, 1999

Graph 8- Population forecasts for 2000-2030 (China)



Source: Policies and programmes on ageing, towards a society for all ages, UN, 1999

Annex 2- Ratios of some structural ratios in the EU and USA

Euro Area: Structural Indicators (1978, 1998)

	Product Market Regulation		Employment Protection		Benefit Replacement Ratio		Labour Tax Wedge	
	1978	1998	1978	1998	1978	1998	1978	1998
Austria	5.2	3.2	0.95	1.30	0.35	0.38	0.56	0.62
Belgium	5.5	3.1	1.55	1.19	0.54	0.47	0.45	0.51
France	6.0	3.9	1.30	1.50	0.55	0.56	0.61	0.68
Germany	5.2	2.4	1.65	1.41	0.40	0.40	0.48	0.57
Ireland	5.7	4.0	0.50	0.54	0.52	0.36	0.26	0.39
Italy	5.8	4.3	2.00	1.41	0.03	0.43	0.54	0.72
Netherlands	5.3	3.0	1.35	1.23	0.65	0.78	0.57	0.39
Portugal	5.9	4.1	1.79	1.91	0.22	0.77	0.26	0.38
Spain	4.7	3.2	1.98	1.62	0.64	0.64	0.31	0.45
UK	4.3	1.0	0.35	0.35	0.34	0.21	0.47	0.47
USA	4.0	1.4	0.10	0.10	0.25	0.32	0.43	0.47

Source: the product market regulation index is taken from OECD 2002 and ranges from 0 to 6, increasing with the restrictiveness of the regulations. All labour market indications are taken from Nickell and Nunziata (2001), 1998 values from OECD data and it spans from 0 (no protection) to 2 (maximum protection). The benefit replacement ratio is the average first year unemployment benefit as a percentage of average earning benefit before tax and the labour tax wedge is the sum of the employment tax rate, the direct tax rate and the indirect tax rate as calculated by Nickell and Nunziata (2001)[14]

[14] This table was taken from the IMF WP/03/174, Reconciling stability and growth: smart pacts and structural reforms by Beetsma, Roel and Debrun, Xavier.

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