Table 1. Determinants of Reforms in Product and Labor Markets
(Dependent variable: change in the relevant structural index times 100)

	Labor market			Product markets		
Explanatory variables	All countries	EU effect 1/	Total EU 2/	All countries	EU effect 1/	Total EU 2/
Cross-border spillovers	5.560 *	-1.619	3.940 **	18.520 ***	-1.091	17.429 ***
Lagged product market reforms	-0.924	5.003 ***	4.079 ***	...	...	...
Lagged labor market reforms	...		...	8.119	-3.506	4.613
Cyclically adjusted primary surplus	0.017	-0.105 ***	-0.089 ***	…	…	…
Change in the cyclically adjusted primary surplus	-0.094 ***	0.114 ***	0.020	0.202 ***	-0.225 ***	-0.023
Net government debt	0.011 ***	0.011 **	0.022 ***	…	…	…
"Bad" year	-0.320 ***	0.545 ***	0.226 ***	0.329 *	0.743 ***	1.072 ***
Number of bad years over the 3 preceding years	0.062 *	-0.172 ***	-0.110 **	0.209 **	0.101	0.311 **
Trade openness	-2.958 ***	4.202 ***	1.244 **	-2.484	0.909	-1.575
Conservative government	-0.143 *	0.381 ***	0.238 **	1.054 ***	-1.230 ***	-0.176
Size of government majority in Parliament	-0.421	0.907	0.486	0.263	-4.864 ***	-4.601 ***
Number of years government is in office	-0.024 *	0.041 **	0.017	…	…	…
Share of seniors (>65 years old) in total population	-0.050 **	-0.184 **	-0.234 ***	…	…	…
Union density	3.442 ***	1.216	4.658 ***	-4.305 **	6.144 ***	1.839
Country size	-5.219	5.514 ***	0.296	…	…	…
Popular support for the euro (Eurobarometer)	-0.003 *	...	-0.003 *	…	…	…
EU membership	5.174 ***	...	5.174 ***	-0.894	…	-0.894
Single European Act (dummy=1 from 1987 onwards)	0.525 ***	...	0.525 ***	1.056 ***	…	1.056 ***
Single market (dummy=1 from 1992 onwards)	0.258 **	...	0.258 **	0.587	…	…
ERM "hard-core" member (excl. Germany)	-1.437 ***	...	-1.437 ***	…	…	…
Adjusted R-squared		0.356			0.252	
Number of observations		346			377	

Note: Both equations were estimated using a feasible GLS estimator allowing for cross-section heteroskedastic and contemporaneously correlated errors (SUR). Significance levels are based on robust standard errors. Superscripts *, **, and *** indicate that the estimated coefficient is significantly different from zero at the 10, 5, and 1 percent level, respectively. The labor equation includes two lags of the dependent variable while the product market equation includes one lag of the dependent variable (not reported). All equations include country fixed effects (not reported).
1/ Coefficients of the EU membership dummy interacted with the corresponding explanatory variable.
2/ Significance levels based on Wald test that the sum of both coefficients is equal to zero.

III. ENFORCEMENT AND THE STABILITY AND GROWTH PACT[39]

Core Questions, Issues, and Findings

- ***Why is the SGP in a procedural impasse?*** The proximate causes were that France and Germany breached the 3 percent deficit limit repeatedly, owing to lack of fiscal adjustment during good times and the effects of automatic stabilizers during the protracted slowdown. But the crux of the matter was that neither the preventive nor the dissuasive procedures of the SGP proved enforceable (¶9-12; ¶31-36).

- ***What aspects of the SGP rendered enforcement difficult?*** First, there seemed to be an imbalance between the SGP's preventive arm, which is rooted in "soft law" and relies mainly on peer pressure, and the SGP's dissuasive arm, which is based on more traditional "hard law" in terms of legal obligations (¶13-21). Second, differing internal incentives within countries meant that some countries found the SGP as an external commitment mechanism more valuable than others. In particular, the SGP seemed more suited to countries which use a "commitment" form of fiscal governance to enforce fiscal discipline. By contrast, countries that used a "delegation" form of fiscal governance, i.e. rely more on a single agenda-setter to enforce fiscal discipline, typically the finance minister, had more limited incentives to adhere to external commitments (¶22-30). The evidence suggests that commitment countries tended to respect the SGP more than delegation countries (¶37-46).

- ***What does this analysis suggest in terms of reforming the Pact?*** It seems to point toward a need to rebalance the Pact's hard and soft law elements. Reforms should make the SGP more enforceable among the delegation states while not undermining its external anchor role for fiscal policy among commitment states (¶47-50).

- ***How can the SGP's preventive arm (soft law component) be strengthened?*** More emphasis could be placed on linking underlying fiscal targets to country-specific fiscal sustainability concerns (¶53-55). Strengthening fiscal institutions could help reduce procyclical fiscal leakages (¶51-52). Peer pressure could also become more effective, by raising the reputational costs of not living up to SGP precepts (¶57-60).

- ***How can the excessive deficit procedure (hard law component) be adapted?*** The dissuasive arm could be tuned better to the proximate reasons that lead to breaches of the 3 percent deficit limit, particularly by distinguishing the effects of policies and economic circumstances. A more flexible time frame for eliminating excessive deficits may also be needed (¶56).

[39] Prepared by Tony Annett.

A. Introduction

130. **The Stability and Growth Pact (SGP), Europe's five-year old fiscal framework, is in abeyance.** In November 2003, the European Commission recommended that the procedures against France and Germany be speeded up given that their excessive deficits were likely to persist for a third consecutive year. While accepting the need to take measures to reduce deficits in 2004, the ECOFIN Council[40] elected not to follow the Commission's recommendations, which would have placed both countries under enhanced fiscal surveillance, one step short of financial sanctions. Instead, they placed the SGP in abeyance, prompting the Commission to challenge what it viewed as a sidestepping of the legal procedures in the European Court of Justice.

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

132. **Against this backdrop, this chapter asks how the SGP can be made more enforceable.** Focusing only on independent enforcement is too narrow. Instead, this chapter explores the different incentives of countries to respect the SGP's precepts, both preventive and dissuasive. It will not touch upon issues related to the optimality of fiscal frameworks directly, unless these issues touch on enforceability. In fact, however, there is a strong overlap between reforms that improve the underlying economic rationale, and those that improve enforceability. The chapter is structured as follows: Section B provides a basic overview of the SGP. Section C delves into the hard and soft law aspects of the SGP. Following from this, the next part (Section D) detours into the political economy literature to ask why some countries respected the tenets of the SGP more than others. With this in mind, Section E then discusses the fiscal policy experience under the SGP. Building on all of this, Section F tentatively presents some options for reform.

[40] The decision making forum for the EU's finance and economics ministers; hereafter referred to as the "Council".

B. Overview of the SGP

133. **The SGP fleshes out the fiscal policy provisions of the Maastricht Treaty.** The Maastricht Treaty, adopted in 1992, provides for a two-pronged fiscal framework—a **preventive arm** focusing on multilateral surveillance and the avoidance of excessive deficits, and a **dissuasive arm** tackling "excessive deficits" once they arise. The SGP in a narrow sense, introduced in 1998, consists of two regulations that provide detailed guidance on implementing the Treaty framework. In this chapter, "SGP" will refer to the Treaty provisions plus the supporting regulations.

The Preventive Arm

134. **The preventive arm urges countries to strive for underlying balance.** It emphasizes economic policy coordination and multilateral surveillance. The Council is empowered under Article 99 of the Treaty to issue Broad Economic Policy Guidelines (BEPGs) and monitor developments in member countries. If it deems that a country's policies are not consistent with the guidelines, it can make recommendations to that country.[41] The SGP beefs up the surveillance function. It complements the 3 percent of GDP deficit limit by requiring countries to strive for a medium-term "close-to-balance or in surplus" objective. This has subsequently been interpreted as a cyclically-adjusted balance requirement.

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

The Dissuasive Arm

136. **The dissuasive arm is charged with ensuring that countries respect the limits on deficits and debt laid down by the Maastricht Treaty.** Countries are obliged to keep their deficits under 3 percent of GDP, and their public debt under 60 percent of GDP. The dissuasive element of the Treaty—Article 104, or the Excessive Deficit Procedure (EDP)—describes what happens when countries breach these reference limits. If countries fail to take

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[41] In 2001, the Council issued a recommendation to Ireland on the grounds that its budget, which entailed tax cuts and expenditure increases, was not compatible with the BEPGs, which called for Ireland to avoid procyclical fiscal policies.

the necessary measures, sanctions can be imposed. The SGP fleshes out the procedure, by detailing each phase in the process, including the timing. One of the goals of this regulation is to speed up the process and allow sanctions to be imposed relatively quickly if the country has not complied with the earlier steps. It also clarifies some of the "escape clauses" embedded in the Treaty (see Box 1 for details).

137. **Ultimately, a non-complying country can be sanctioned.** The Treaty prescribes a range of option for sanctions: requiring the member state to publish additional information before issuing bonds; inviting the European Investment Bank to reconsider its lending policy to the country; requiring the member state to make a non-interest bearing deposit; and imposing fines. The SGP regulation states that non-interest bearing deposits are required "as a rule". While sanctions are at the prerogative of the Council, the framers of the SGP wanted to make sanctions "quasi-automatic" (Stark, 2001).

Procedural Impasse

138. **The Council first balked at issuing early warnings.** It opted not to follow Commission recommendations to send early warnings to Portugal and Germany in early 2002. Later, however, the Council decided to send a warning to France in January 2003. Following a promise by the authorities to take action to reduce the likelihood of breaching the 3 percent limit, the Council opted not to send an early warning to Italy in April 2004.

139. **To date, five euro-area countries have been subject to the EDP.** The Council launched the procedure against Portugal in November 2002, and closed it in April 2004, noting that Portugal had complied with the recommendations and kept its deficit below 3 percent in 2002 and 2003. In the case of Germany, the EDP was initiated in January 2003; in response to the requirement to adjust within four months, Germany committed to, and implemented, measures equal to 1 percent of GDP. The Council launched the EDP against France in June 2003, again giving it four months to take effective action. France did not implement the required measures over this period. The EDP was also launched against Greece and Netherlands in 2004. Finally, six of the ten new members—Czech Republic, Cyprus, Hungary, Malta, Poland, and Slovakia—were placed under the EDP upon accession in May 2004, although as non-euro-area members, some of the dissuasive aspects of the SGP (enhanced fiscal surveillance and sanctions) do not apply to them.

140. **In November 2003, the Commission recommended ratcheting up the process for both France and Germany.** Although Germany had implemented corrective measures, it seemed that the excessive deficit would persist into 2004. Accordingly, the Commission recommended that the Council give notice under Article 104.9 to France and Germany. First, the countries should take measures sufficient to reduce their cyclically-adjusted deficits in 2004—1 percent of GDP for France, and 0.8 percent of GDP for Germany. Second, recognizing the adverse economic circumstances

Box 1. The Excessive Deficit Procedure

Is there an excessive deficit? A deficit greater than 3 percent of GDP will trigger the EDP as long as the excess is not considered to be exceptional, temporary, and close to the reference value. This criterion is also satisfied if the deficit has declined substantially and continuously and comes close to 3 percent of GDP. A similar caveat for the debt ratio is even looser: in this case, all that needs to happen is for the ratio to be approaching the 60 percent of GDP threshold at a satisfactory pace. When preparing its initial report under the EDP, the Commission takes into account whether the deficit exceeds government investment and also considers "all other relevant factors, including the medium-term economic and budgetary position of the member state".

What are exceptional circumstances? Exceptional is defined as resulting from "an event outside the control of the member state... which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn". In turn, a severe economic downturn is defined as a fall in real GDP by at least 2 percent. A fall between 0.75 and 2 percent may be exceptional, given supporting evidence. A less than 0.75 percent decline is not. The deficit is temporary if it will "fall below the reference value following the end of the unusual event or the severe economic downturn". The SGP does not define the "closeness" criterion. All three must apply for this escape clause to be utilized.

First stage: Within *three months* of the reporting date, the Council decides on whether an excessive deficit exists (Article 104.6). If so, it will immediately issue a recommendation under Article 104.7. Two deadlines are presented: (a) four months to take "effective action" and; (b) a deadline for the elimination of the excessive deficit, which is typically the year following its identification, barring "special circumstances".

Second stage: After *four months*, if the Council feels that the member state is not implementing the measures, or that they are inadequate, or that data indicate that the excessive deficit will not be corrected within the time limits specified, then it will move on to the next step. If the country is deemed to have taken effective action, the procedure is placed in abeyance. Otherwise, within *one month*, the Council will give notice under Article 104.9 for the member state to take, within a specified time limit, measures to reduce the deficit. This stage is only applicable to countries in the final stage of EMU. The Council may request the member state to submit regular reports to monitor adjustment efforts under enhanced fiscal surveillance.

Final stage: If the member state is in compliance with the notice given, the procedure is held in abeyance. If not, then the Council will move to the sanctions phase within *two months* (Article 104.11). By this timetable, sanctions can be imposed within ten months of the reporting date. A non-interest bearing deposit will be required. The first deposit comprises a fixed component of 0.2 percent of GDP and a variable component equal to one tenth of the difference between the deficit and the 3 percent, in percent of GDP. Each following year, the Council may decide to intensify the sanctions by requiring another deposit (variable component only). No single deposit can exceed 0.5 percent of GDP. If the excessive deficit has not been corrected two years after the deposit was made, it shall be converted into a fine. If, before two years are up, the Council considers the excessive deficit to be corrected, it abrogates the procedure and returns the deposit. Fines are not reimbursed. Interest on deposits, and fines, shall be distributed among member states without excessive deficits (proportional to their share in total GDP).

facing them, the countries were given an extra year (until 2005) to eliminate their excessive deficits. Third, again in accordance with Article 104.9, the countries would be placed under enhanced fiscal surveillance—an initial report would be due in December 2003, followed by regular implementation reports.

141. **The Council did not endorse these recommendations, opting instead to place the EDP against France and Germany in abeyance.** The differences between the Commission and the Council were largely procedural, and did not involve significant disagreement about the desirable fiscal stance. The Council endorsed the commitment of France and Germany to marginally lower adjustment in 2004 (0.8 percent and 0.6 percent of GDP respectively) while agreeing with the Commission on the need to eliminate the excessive deficit by 2005. However, it did not move to the next step in the procedure—enhanced fiscal surveillance. The Commission has taken the case to the European Court of Justice, challenging the legal basis under which the Council acted.

C. Hard Law, Soft Law, and the SGP

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

143. **Traditionally, policy coordination in the EU has emphasized hard law.** Decision-making was centralized, and the Commission was endowed with a significant agenda-setting role. The liberalization of product markets, under the auspices of the Single European Act, broadly followed this pattern. Such a centralized approach to policy coordination is more advantageous when there are substantial economics of scale and spillovers, and where preferences are not too heterogeneous (Alesina and Wacziarg, 1999).

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

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

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

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

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

145. **In fact, the EU now leans heavily on soft law in many aspects of economic policy coordination.** Partly in response to perceptions of excessive centralization, the Maastricht Treaty deliberately embraced the principle of subsidiarity, which allows for greater country autonomy. Different aspects of EU policy coordination occupy different areas of the hard-soft scale (Begg, Hodson, and Maher, 2003). While hard coordination emphasizes top-down policy formulation and financial penalties for non-compliance, the softer approach uses guidelines and codes, peer review, and benchmarking. A related concept adopted by the EU in recent years is the open method of coordination. This refers to a policy process that stresses subsidiarity over centralization, and relies on consensus building around a common assessment of the situation and agreement on the appropriate policy response (Hodson and Maher 2001). It recognizes the importance of surveillance, peer review, and peer pressure in enforcement, and eschews legally binding rules and the threat of sanctions in favor of non-binding recommendations. The Lisbon agenda uses this form of economic governance to urge countries to undertake structural reforms (see Chapter II).

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

147. **The inherent uncertainty in fiscal policy favors soft law.** A degree of flexibility is often prized alongside fiscal discipline. In the context of the SGP, even assessing the medium-term underlying balance is riddled with uncertainty. Hodson (2004) goes further and points to diagnostic uncertainty about the exact nature of the fiscal policy spillover, and prescriptive uncertainty over whether such coordination is even the right response to a fiscal

spillover. More generally, the unknown nature of future economic shocks calls for an element of flexibility. Such flexibility can also take account of "divergent national circumstances" and foster greater legitimacy among governments.

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

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

150. **The uneasy mix of hard and soft law in the SGP has been a source of tension.** For a core group of countries, self-enforcement did not always work and peer pressure did not act as a strong enough deterrent. There may therefore be an argument for "hardening" the preventive aspect, to make peer pressure more effective. At the same time, the dissuasive arm has been criticized as too rigid, lacking in legitimacy. Although they had not adjusted in accordance with the preventive arm, France and Germany saw their excessive deficits as resulting largely from the operation of automatic stabilizers during the protracted slowdown. A feeling that the dissuasive arm lacks legitimacy could feed back to the earlier stage, lessening the incentives of countries to respect the tenets of the preventive arm. A case could also be made, therefore, for "softening" the dissuasive arm, which would better distinguish between the effects of poor policies and weak economies and reserve sanctions for egregious policy misbehavior. Such reforms could go hand-in-hand with greater flexibility at the preventive stage, to increase the overall legitimacy of the framework.

D. The SGP and Fiscal Governance

151. **The theme of this section is that the SGP could be more suited to some countries than others, in particular to countries for which an external commitment technology proves especially valuable.** To prevent fiscal policy drift, or to curb politically-motivated deficits, policymakers can latch onto the rules embodied in the SGP to anchor fiscal behavior. In a very loose sense, the SGP replicates the advantages of the old Bretton Woods system in a monetary union; instead of relying on the exchange rate peg to maintain discipline, countries can now make use of a fiscal anchor. However, not all countries require such a disciplining device. Much as countries with strong domestic governance mechanisms were able to enjoy the flexibility of a floating exchange rate without negative policy repercussions, so too is the SGP of less relevance to a significant subset of member states. In a nutshell, some countries can make better use of the external anchor than others, and this has implications for enforcement.

152. **On one dimension, fiscal governance is related to the quality of domestic budgetary institutions.** If there is insufficient coordination in the budgetary process, spending ministers may fail to internalize the costs of their demands on society as a whole. Applying the logic of the common pool model, a more fragmented budget process—with more autonomous agents—will lead to a deficit or expenditure bias. There are a number of institutional solutions which can facilitate budgetary coordination and minimize the common pool problem.

153. **A *delegation* strategy, which relies on strong domestic governance institutions, can foster fiscal discipline.** The common pool problem can be overcome through the choice of an appropriate domestic agenda-setter. For example, the finance minister may be granted a leading role in the budget process, from negotiation through design, implementation, and monitoring.

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

155. **The choice between delegation and commitment technologies seems to be related to the electoral system** (Hallerberg and von Hagen, 1999; von Hagen, 1998). By this reasoning, delegation is seen as more suited to single-party governments, where there are few policy differences on the budget. The ultimate sanction for a non-complying spending minister is dismissal from office. Even without going this far, the finance minister's first-among-equals position, with the backing of the prime minister, can be used to ensure

compliance. It is unlikely that coalition partners will agree to vest a single agent with agenda-setting power. In such a case, commitment is the more logical choice, and the threat of breaking up a coalition serves as the enforcement mechanism. Finally, the mixed system may work well with single party minority governments, where the budget is set by one party, and then negotiated with the opposition to secure passage through parliament.

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

157. **Hallerberg (2004) found that most EU countries have reformed their budgetary institutions in recent years.** Based on detailed case studies, Hallerberg (2004) classifies the EU countries by forms of fiscal governance over the past two decades (see Box 2 for details). In his scheme, the traditional delegation states are France, Germany, and the United Kingdom; these countries have had relatively stable institutions over the past few decades. Italy switched to the delegation model in 1996, as did Greece in 1997. He also notes that a large number of countries adopted the commitment technology. Some countries reformed prior to Maastricht, while for others, reducing the deficit to qualify for EMU was clearly a motivating factor. Finally, Portugal is seen as the one country which still maintains a fragmented budget system.[42]

158. **Within this framework, the SGP works in the spirit of the commitment approach.** Like domestic commitment technologies, the SGP places a lot of weight on multi-annual targets and a regular review procedure. The main difference is that the mechanisms of the SGP rely on an external agent to enforce the fiscal contracts (von Hagen, Hughes Hallett, and Strauch, 2000). The SGP wraps neatly around the kinds of domestic rules that embody commitment, but the fit with delegation is less smooth. In delegation countries, fiscal policy will be based on domestic considerations and constraints, with few incentives to abide by SGP rules. In commitment states, on the other hand, the SGP reinforces domestic fiscal rules, and can provide an added impetus for all sides to live up to their side of the bargain, especially if the external actor is credible.

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[42] This classification simplifies Hallerberg (2004). In his interpretation, Austria exhibited brief interludes when commitment broke down, and attempted to move to delegation in 2000. Similarly, Spain shifted subtly away from mixed to delegation around this time. Since Hallerberg's case studies for these countries are less detailed than others, and do not analyze the post-2000 period, these complications are ignored here.

Box 2. Forms of Fiscal Governance in Euro Area Countries

Delegation		**Commitment/Mixed**		**Unreformed**	
France	throughout	Belgium	1993	Portugal	throughout
Germany	throughout	Finland	throughout		
Italy	1996	Ireland	1988		
Greece	1996	Luxembourg	throughout		
		Netherlands	1983 (strengthened 1994)		
		Austria	1987		
		Spain	1994		

Source: Hallerberg (2004).

159. **The SGP offers substantial additional benefits to commitment countries through its external anchor.** Of course, a strict reading of this political economy approach would argue that the SGP, while compatible with commitment, is not strictly necessary for fiscal discipline. Commitment is fundamentally a domestic technology. Still, there are good reasons to think that the SGP can bolster the efficacy of commitment. First, it allows for closer fiscal policy coordination, around the shared goal of "close to balance or in surplus." Second, and more basically, the SGP can strengthen the commitment technology when external enforcement is superior to the domestic variety. In this sense, the SGP takes over the role once played by the Bretton Woods system. Indeed, it is possible to embrace a more general interpretation of commitment, going beyond the basic political economy story—the incentives towards over-spending within coalition governments—and encompassing any domestic policy coordination problem that can be rectified with an external anchor. In this context, it may be no coincidence that most of the commitment countries in the Hallerberg (2004) dichotomy are also smaller, more open economies.

E. Fiscal Policy Behavior Under the SGP

Overview

160. **EU countries' fiscal discipline records prior to the signing of the Maastricht Treaty were widely divergent.** Some countries ran large and persistent deficits, which fed into rapid public debt accumulation, while others preserved a remarkable degree of fiscal discipline (Table 1). By the early 1990s, gross public debts in Belgium, Greece, Ireland, and Italy had spiraled to over 100 percent of GDP, with fiscal policies clearly on unsustainable paths. The average general government deficit in these countries hovered around 10 percent of GDP throughout the 1980s. On the other hand, public debt accumulation in core countries like France and Germany had traditionally been kept in check, and public debt levels remained moderate.

Table 1. Fiscal Policy in the Euro Area, 1980-2003

(In percent of GDP)

	Overall balance			Structural balance			Government debt		
	1980-90	1991-1998	1999-2003	1980-90	1991-1998	1999-2003	1980-90	1991-1998	1999-2003
Euro area	-4.5	-4.5	-1.6	-5.0	-4.2	-1.7	50.1	71.3	71.4
Austria	-2.3	-3.5	-1.2	-1.8	-3.5	-0.9	48.4	63.5	66.9
Belgium	-10.3	-4.8	0.1	-10.7	-4.9	-0.9	112.8	130.6	107.9
Finland	4.1	-3.2	4.2	-1.9	-2.5	3.8	15.1	49.2	44.8
France	-2.3	-4.2	-2.4	-2.5	-2.9	-2.3	29.3	49.9	58.8
Germany	-2.0	-2.8	-2.1	-1.3	-3.1	-2.2	39.2	52.5	61.2
Greece	-9.6	-8.9	-1.9	-14.3	-8.9	-2.2	48.8	102.7	105.1
Ireland	-8.5	-1.1	1.4	-8.2	-0.5	0.7	90.0	80.8	37.9
Italy	-10.9	-7.8	-1.9	-11.2	-7.3	-2.3	78.6	116.7	110.1
Luxembourg	2.1	2.1	3.5	2.2	4.1	5.4	9.8	6.4	5.5
Netherlands	-4.9	-2.7	-0.5	-5.0	-2.8	-1.2	67.5	75.9	56.5
Portugal	-5.9	-4.3	-3.1	-6.1	-4.3	-3.0	64.5	60.8	56.3
Spain	-4.0	-4.9	-0.4	-6.2	-4.3	-0.3	35.3	58.7	56.9
Average EU-12	-4.5	-3.8	-0.4	-5.6	-3.4	-0.4	53.3	70.7	64.0

Source: WEO.

161. **Historically, fiscal policy in EU countries also tended to be highly procyclical, muffling in part or in full the operation of automatic fiscal stabilizers** (European Commission, 2001). Procyclicality tended to be especially pronounced during good times (Jaeger, 2001; Skilling, 2001), and was seen as a leading cause of debt accumulation. Factors that facilitated procyclicality included a large PAYG system and a sizeable lower government sector (Jaeger, 2001), dispersed political power (Lane, 2002), and coalition governments (Skilling, 2001).

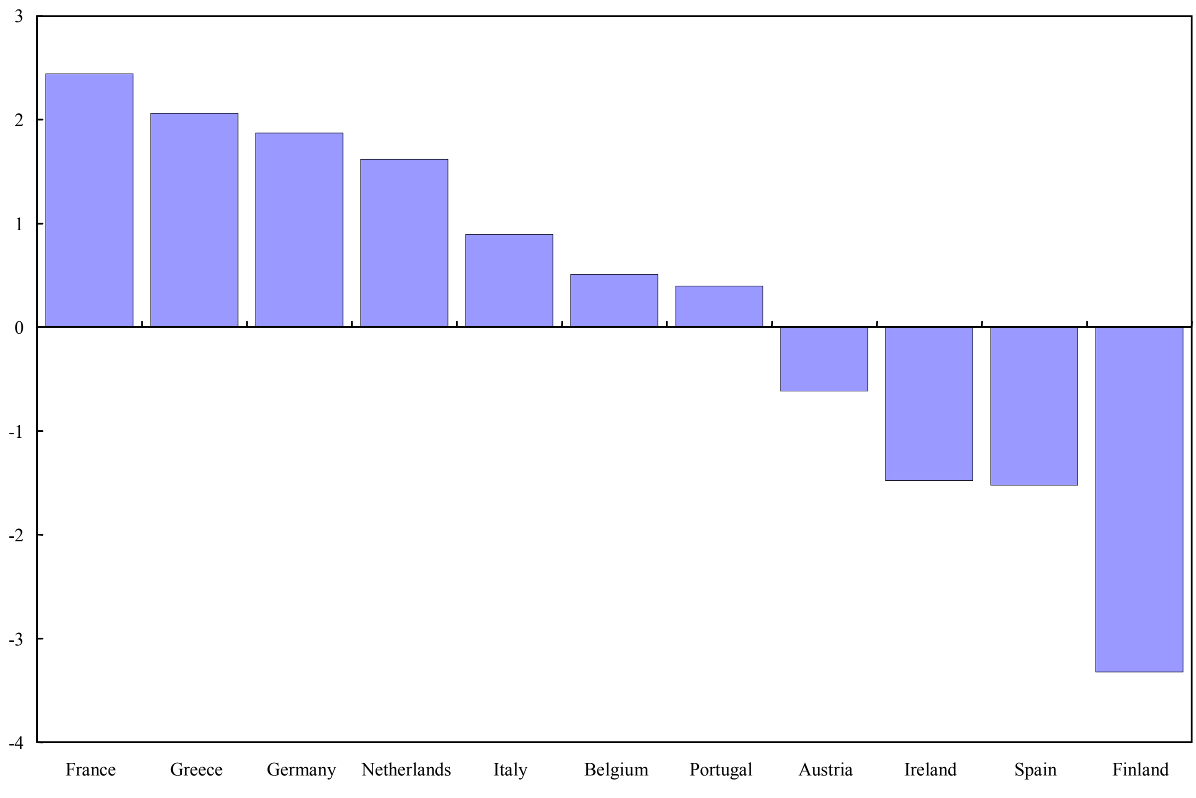
162. **The ratification of Maastricht spurred countries into action as they scrambled to meet the deficit criterion.** Most countries underwent substantial fiscal adjustment in the 1990s (see IMF, 2001; von Hagen, Hughes Hallett and Strauch, 2000). As a result, by the onset of EMU in 1999, all of the present euro-area member countries had succeeded in bringing their deficits under 3 percent of GDP. A good one-third of the member countries were even running surpluses at this point, including some with histories of high public debt accumulation.

163. **The SGP has proven generally conducive to fiscal discipline.** Looking at the big picture, the average euro area deficit over the period 1999-03 stood at 1½ percent of GDP, a full 3 percentage points below the earlier post-Maastricht era (1992-98) average. The (unweighted) average deficit fell to a mere ¼ percent of GDP, down by even more. A similar story can be told for the structural balance. Indeed, from this viewpoint, the scale of consolidation over the past five SGP years surpassed the earlier 1990s adjustment, a time when countries were clambering to reach the 3 percent limit. One interesting development is that those countries with a history of low stable deficits—France and Germany in particular—did not change their behavior. Given the extent of adjustment among the other countries, this catapulted the previous star performers to the bottom of the pack during the

SGP period. They were joined by Greece and Italy, two traditionally high-debt countries that had undertaken major adjustment in the 1990s, although it was insufficient to attain close-to-balance.

164. **Despite the generally favorable fiscal performance, the close-to-balance condition proved elusive for a number of countries.** In fact, by the end of 2003, only five countries could comfortably meet this criterion, defined rather loosely as a maximum structural deficit of ½ percent of GDP—Austria, Finland, Ireland, Luxembourg, and Spain (see Figure 1). Of the others, France and Germany had the most ground to cover, requiring adjustment of 2½ and 2 percent of GDP respectively, followed by Greece and Italy. France and Germany failed to be affected by the SGP requirement to achieve underlying balance, instead maintaining a structural deficit which hovered around the historical average (2-2½ percent of GDP).

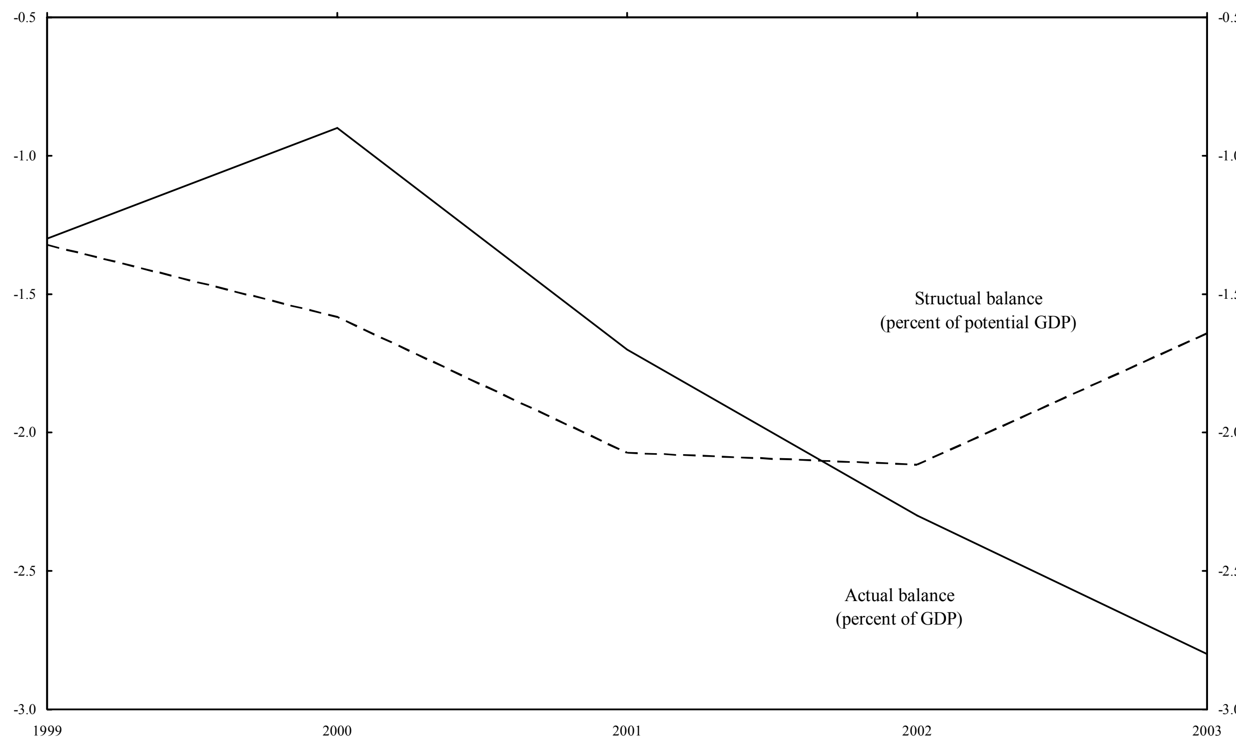
Figure 1. Adjustment in Structural Balance Needed to Reach "Close-to-Balance" (0.5 Percent of GDP Deficit), 2003



165. **Fiscal policy also seems to have become less procyclical under the SGP.** In contrast with past patterns, various studies have also shown that procyclicality was more muted under Maastricht (Gali and Perotti, 2003) or the SGP when the emphasis shifted from nominal to structural balances (Fatas and others, 2003). Glancing over the most recent cycle (1999-03), the structural balance barely budged while the overall balance rose steadily, as automatic fiscal stabilizers were allowed to operate unhindered, especially in the downturn phase (Figure 2). Table 2 contrasts the degree of adjustment during the good times phase

(1999-00) and the ensuing downturn (2001-03) for each country. On average, the automatic stabilizers were allowed to work, with an improvement in the balance during the boom almost matched by a corresponding decline during the downturn. About half of the countries consolidated during the upswing, leading to a small increase in the average structural balance. A number of countries failed to take advantage of the propitious circumstances to push for underlying balance; for France and Germany in particular, the structural balance barely moved during the upswing, while it deteriorated during the downturn. Other countries consolidated during the downswing, suggesting some remnants of procyclical policy in the push for close-to-balance. Still, four countries engaged in countercyclical fiscal policy throughout the cycle.

Figure 2. General Government Balances Under the SGP



Source: WEO, IMF.

Table 2: Fiscal Adjustment under the SGP

(Cumulative change, in percent of GDP)

	Overall balance			Structural balance		
	Good times (1999-00)	Bad times (2001-03)	Overall (1999-03)	Good times (1999-00)	Bad times (2001-03)	Overall (1999-03)
Austria	0.8	0.2	1.1	-0.2	2.8	2.6
Belgium	0.9	0.1	1.0	-1.0	0.7	-0.3
Finland	5.4	-5.0	0.5	6.0	-3.2	2.8
France	1.3	-2.7	-1.5	-0.3	-0.9	-1.2
Germany	3.5	-5.4	-1.8	0.1	-0.8	-0.7
Greece	0.4	-1.2	-0.7	0.0	-0.1	-0.1
Ireland	2.0	-4.6	-2.6	0.7	-1.8	-1.1
Italy	2.2	-1.8	0.4	0.5	1.0	1.4
Luxembourg	3.2	-7.4	-4.2	-0.1	-3.4	-3.5
Netherlands	3.0	-5.4	-2.4	1.3	-2.0	-0.7
Portugal	-0.3	0.1	-0.3	-1.1	3.0	1.9
Spain	2.3	1.1	3.3	1.0	2.2	3.3

Source: WEO and staff calculations.

Explaining the Outcome

166. **Under the SGP, euro area countries are dividing into two camps: those near underlying balance, and those not.** There are a number of possible explanations for the emerging division:

- ***Country size:*** The SGP is more suited to small countries. Small countries are more accustomed to external influences over policy (Von Hagen, Hughes Hallett, and Strauch, 2000). They have less bargaining power, and so the loss of reputation for violating the rule is greater (de Haan, Berger, and Jansen 2003). Small countries could also fear the loss of transfers such as structural funds. Another variant of the country size hypothesis argues that small countries tend to be less heterogeneous, making simple numerical rules easier to apply. Large countries are therefore more apt to go for procedural solutions (Eichengreen, 2003).[43]

[43] This variant is less compelling given that some smaller countries, such as Belgium, are among the most heterogeneous in the region.

- *Volatility:* The discipline engendered by the SGP is more attractive to countries with a record of macroeconomic and fiscal volatility. Such countries are more inclined towards prudence and a rules-based framework. In an EMU environment, an external commitment technology is especially valuable.

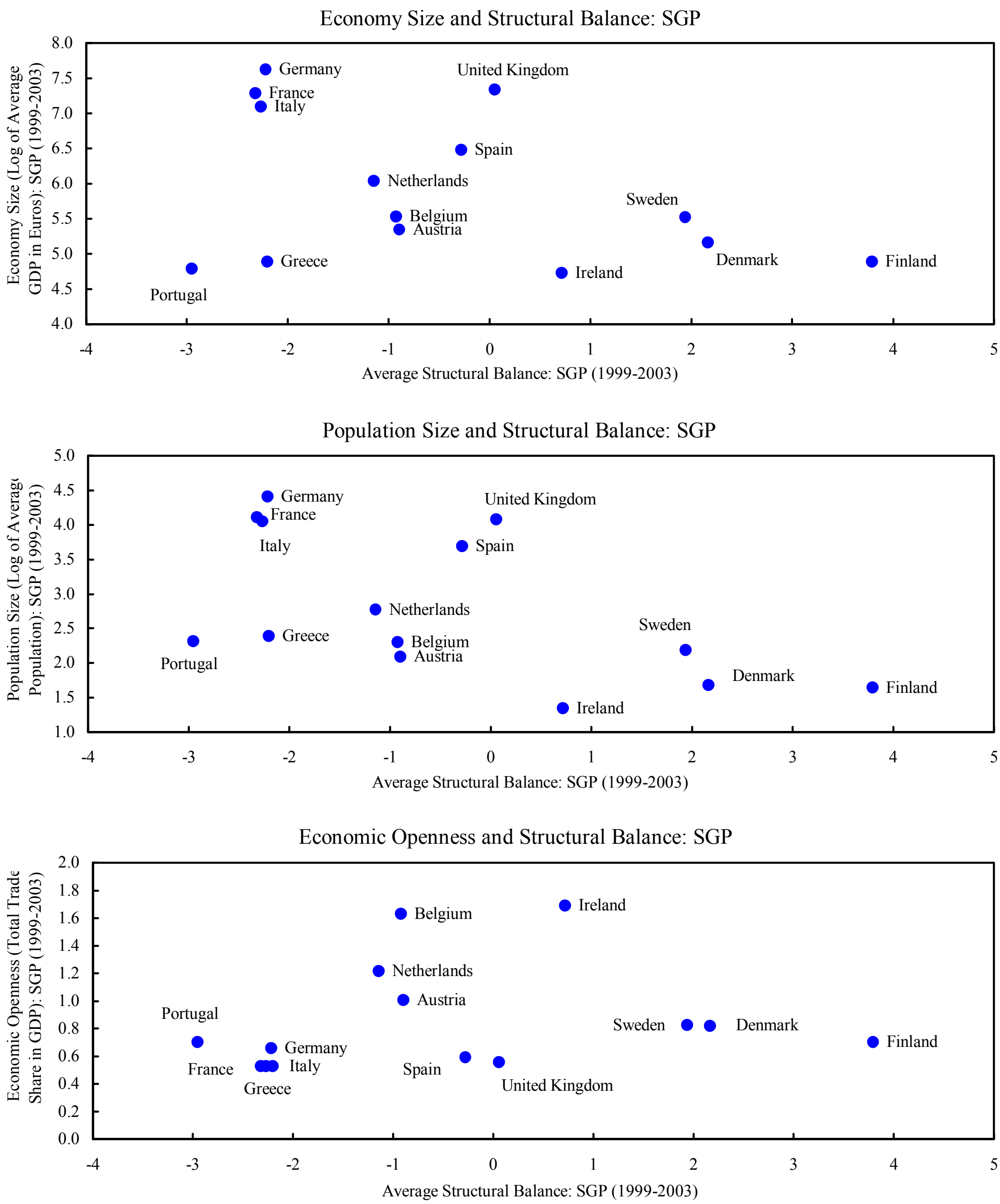
- *Fiscal governance:* The SGP is more suited to commitment than delegation countries (Hallerberg, 2004). With its emphasis on multi-annual targets, the SGP fits snugly with the numerical contracts approach in commitment states, but not so well with states which rely on domestic governance institutions.

167. **These explanations are by no means mutually exclusive.** Small countries tend to be more open, and more prone to external shocks (Alesina and Wacziarg, 1998). Small countries also tend to be more amenable to a commitment technology. Moreover, excess volatility in the past could signal policy weakness and overlap with weak domestic fiscal governance mechanisms. There is also a noted tendency for small, open economies to adopt proportional political systems, which in turn makes commitment more suitable (Rogowski, 1987). So the SGP could be suited to a subgroup of countries, because (i) they are small and more likely to accept an external constraint; (ii) they have the potential for macroeconomic volatility and so appreciate an external anchor; and (iii) their form of fiscal governance emphasizes the need for a robust commitment technology.

168. **Smaller and more open countries seemed to run more prudent fiscal policies under the SGP.** Figure 3 suggests a negative relationship between the average structural balance under the SGP period and size, whether measured by GDP or by population. However, this hypothesis fails to explain why two small countries, Greece and Portugal, did not adjust more. Figure 3 also depicts a positive relationship between the SGP-era structural balance and openness, defined as the ratio of exports plus imports to GDP; while this could provide a better explanation for the behavior of Greece and Portugal, the Nordic countries are outliers.

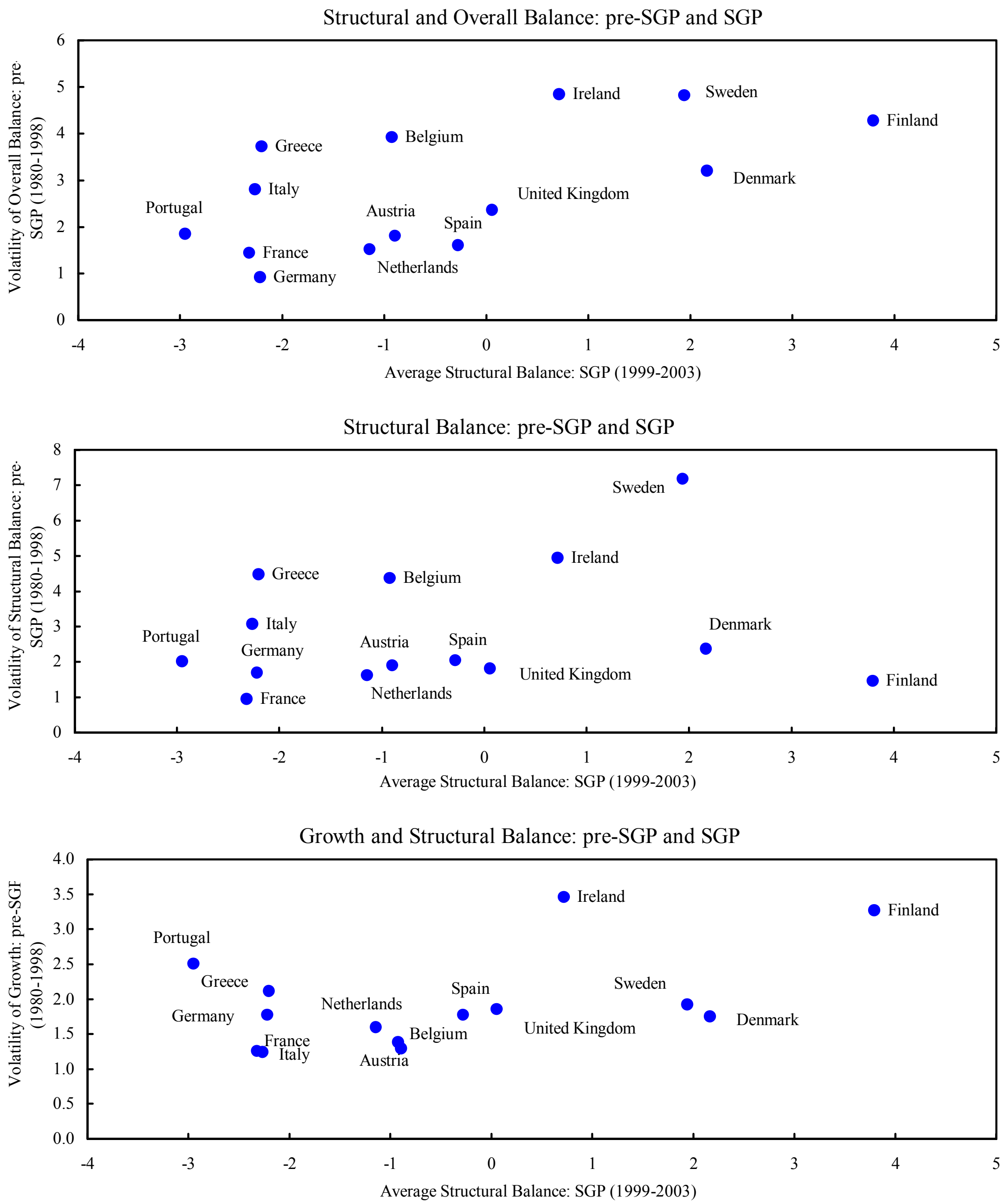
169. **The volatility hypothesis suggests that those countries which have historically experienced large swings in macroeconomic variables would be more apt to latch onto an anchor like the SGP**. Indeed, there has been a noted reduction in the volatility of fiscal policy under the SGP (Fatas and Mihov, 2003). Figure 4 plots the average structural balance during the SGP period against volatility in pre-SGP times (1980-98). There seems to be a positive association between historical swings in growth and fiscal discipline under the SGP. Of course, the volatility in the overall balance could be policy induced, although the seemingly weaker relationship between balances under the SGP and historical structural balance variability casts some doubt upon this.

Figure 3. The SGP, Country Size, and Openness



Source: IMF.

Figure 4. The SGP and Volatility



Source: IMF.

170. **The advantage of the fiscal governance hypothesis is that it can explain the relatively weak performers under the SGP: France, Germany, Italy, Greece, and Portugal**. Fiscal policy behavior for France and Germany has not changed much under the SGP, suggesting that it had not made an impact on the prevailing form of fiscal governance. For Italy and Greece, the adoption of delegation coincided with dramatic deficit reduction, but adjustment tapered off under the SGP. Finally, Portugal seems to be the only remaining euro area country not to have reformed its institutions in either a delegation or a commitment direction.

171. **The fiscal governance explanation is also consistent with some simple regression results.** Table 3 displays a number of results based on regressing the average structural balances under the SGP from a cross-section of the EU countries[44] (excluding Luxembourg) on a number of potential explanatory variables. Caution is needed in interpreting these results, given the limited degrees of freedom. Still, some interesting findings emerge. First, there is some evidence that size matters, in that larger countries were associated with smaller structural balances in the SGP era, but only when measured by population, not economy. Moreover, this result is not robust to the inclusion of a dummy representing commitment countries, a variable with a statistically significant coefficient.[45] Furthermore, the coefficient on openness is not statistically significant. Table 4 provides some evidence that, with the same econometric caveats, countries with higher past volatility in growth and the overall balance (but not in the structural balance) are more inclined towards prudent fiscal policy under the SGP. Interestingly, this conclusion is robust to the inclusion of the commitment dummy, which is again statistically significant. It should be reiterated that these results are suggestive at best. Moreover, in focusing on the external commitment hypothesis, this analysis abstracts from other plausible economic and political factors which could affect compliance such as cyclical developments, elections, and the degree of local government autonomy.

[44] Given the low sample size, the regression analysis incorporates the 14 EU countries, excluding Luxembourg. The results all hold for the sub-sample of euro area economies.

[45] Delegation states comprise France, Germany, Italy, Greece, and the United Kingdom, while commitment states comprise all the others bar Portugal. For the purposes of the analysis in this section, “mixed” states are placed under the commitment banner, given that these states also employ fiscal contracts and numerical targets.

Table 3. SGP Era Regressions (I) 1/

	[1]	[2]	[3]	[4]
Constant	2,43*	3.79	-1.25	1.41
	(1.35)	(3.05)	(1.36)	(2.23)
Log population	-1.04**			-0.57
	(0.45)			(0.51)
Log GDP		-0.72		
		(0.51)		
Openness			0.92	-2.31
			(1.46)	(1.34)
Commitment 2/				2.96**
				(1.13)
R^2	0.30	0.14	0.03	0.60
NOBS	14	14	14	14

Source: staff estimates.

1/ Cross sectional OLS; standard errors in parentheses. Superscripts *, ** and *** indicate that the estimated coefficient is significantly different from zero at the 10 percent, 5 percent, and 1 percent levels respectively.
2/ Dummy for Belgium, Denmark, Finland, Ireland, Netherlands, Austria, Spain, Sweden.

Table 4. SGP Era Regressions: (II) 1/

	[1]	[2]	[3]	[4]
Constant	-3.06*	-3.05**	-1.16	-3.78***
	(1.50)	(1.05)	(1.07)	(1.17)
Volatility in GDP growth 2/	1.33*			1.00*
	(0.73)			(0.57)
Volatility in overall balance 2/		0.93**		
		(0.34)		
Volatility in structural balance 2/			0.25	
			(0.32)	
Commitment 3/				2.40***
				(0.78)
R^2	0.22	0.38	0.05	0.58
NOBS	14	14	15	14

Source: staff estimates.

1/ Cross sectional OLS; standard errors in parentheses. Superscripts *, ** and *** indicate that the estimated coefficient is significantly different from zero at the 10 percent, 5 percent, and 1 percent levels respectively.
2/ Standard deviation over pre-SGP periods (1980-98).
3/ Dummy for Belgium, Denmark, Finland, Ireland, Netherlands, Austria, Spain, Sweden.

172. **Commitment countries have managed to adjust toward close-to-balance while delegation countries have not.** The simple econometric evidence points to being a commitment country, more than anything else, as the driving factor in explaining performance under the SGP. Figure 5 shows the diverging experience of the two groups: while commitment countries continued to adjust under the SGP and reached aggregate structural budgetary balance, the fiscal positions of delegation countries actually deteriorated. Table 5 also looks at the difference between the two groups of countries over the last cycle, but using unweighted country averages. By adjusting more in good times, the "average" commitment state could afford the luxury of a larger countercyclical effect during the downturn while still managing to adjust over the cycle.[46] The "average" delegation state failed to adjust.

Table 5. Fiscal Adjustment and Fiscal Governance under the SGP

(Cumulative change, in percent of GDP)

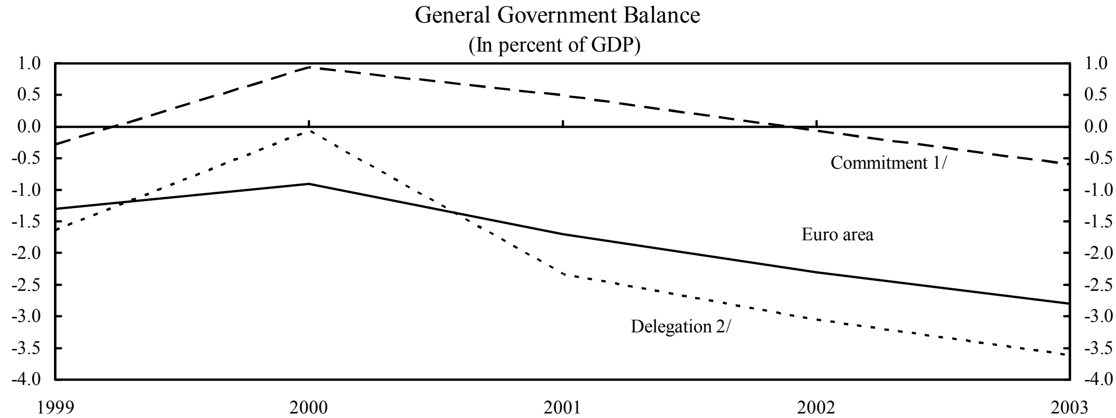
	Adjustment			Structural balance, 2003
	(in good times)	(in bad times)	(whole SGP period)	
Average, EUR12	0.6	-0.2	0.4	-0.5
Average, delegation	0.1	-0.2	-0.1	-2.3
Average, commitment	1.1	-0.7	0.4	0.7
Unreformed	-1.1	3.0	1.9	-0.9

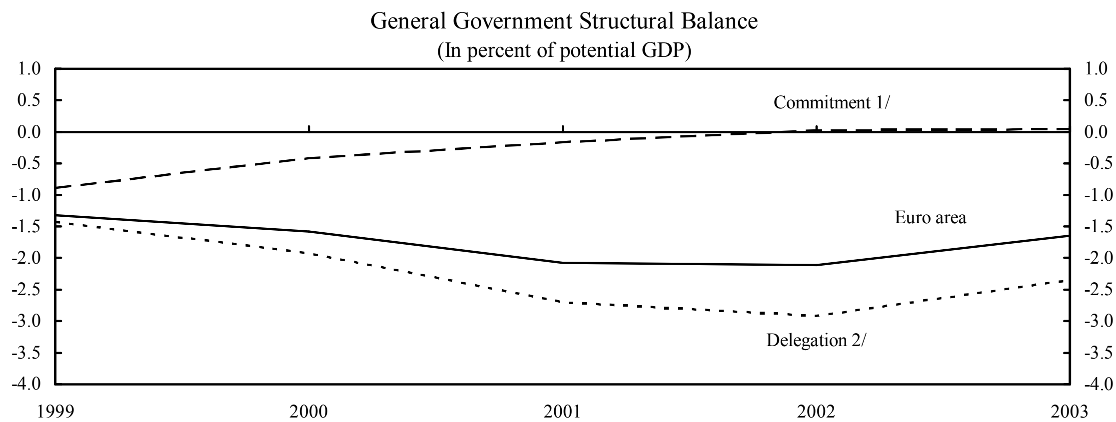
Source: WEO.

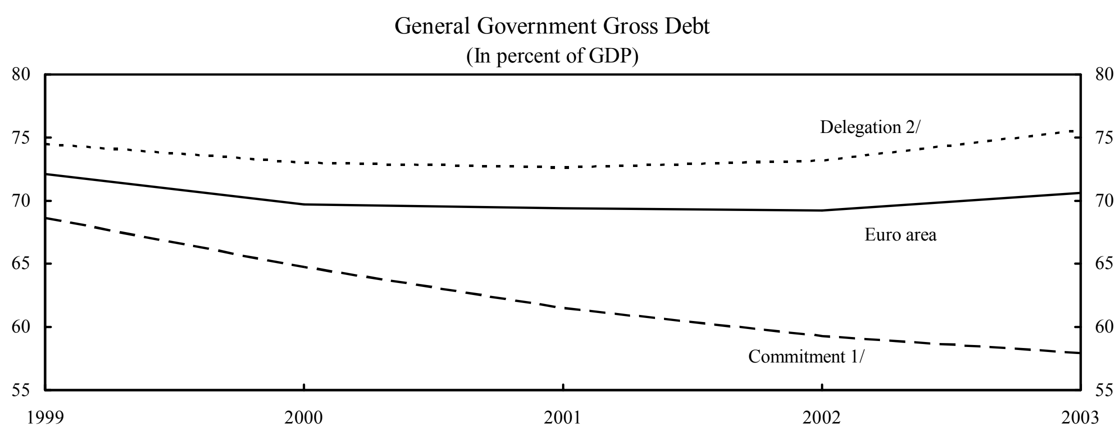
173. **A number of conclusions can be drawn from the behavior of countries before and after they reformed their budgetary institutions** (Table 6). First, countries that have used delegation for the entire period (France and Germany) experienced little change in fiscal policy under the SGP; both the absolute and structural balances remained in the historical range (2-2½ percent of GDP). Second, those who had always employed commitment technology (Finland and Luxembourg) saw their surpluses increase substantially under the SGP. Third, while both "new" delegation countries (Greece and Italy) and "new" commitment (Austria, Belgium, Ireland, Netherlands, Spain) countries experienced dramatic consolidation in the aftermath of institutional reforms, the pace of adjustment continued for the latter, and tapered off for the former under the SGP. Fourth, spending declined in commitment countries under the SGP, while it rose in delegation countries; this is confirmed by the pattern of structural primary expenditure, pointing to the discretionary nature of the divergence. Fifth, delegation countries dealt with the SGP by raising revenue, while commitment countries did not, and some actually cut taxes. Sixth, differences cannot be explained by diverging growth patterns across countries in the pre and post-SGP periods.

[46] This is the unweighted average, meaning that this table is not strictly compatible with Figure 5.

Figure 5. Diverging Fiscal Policy Under the SGP







Source: WEO, IMF.
1/ Austria, Belgium, Finland, Ireland, Luxembourg, Netherlands, and Spain.
2/ France, Germany, Greece, and Italy.

Table 6. Fiscal Policy, the SGP, and Forms of Fiscal Governance 1/

(In percent of GDP, except as indicated)

		Before	After	SGP	Difference
OVERALL BALANCE	Always delegation 2/	...	-2.7	-2.3	0.5
	Always commitment 3/	...	1.6	3.8	2.3
	Switch to commitment 4/	-6.3	-3.5	-0.1	3.4
	Switch to delegation 5/	-10.3	-3.7	-1.9	1.8
STRUCTURAL BALANCE	Always delegation 2/	...	-2.4	-2.3	0.1
	Always commitment 3/	...	0.4	4.6	4.2
	Switch to commitment 4/	-6.5	-3.1	-0.5	2.6
	Switch to delegation 5/	-11.3	-3.4	-2.2	1.2
EXPENDITURE	Always delegation 2/	...	50.1	50.7	0.6
	Always commitment 3/	...	46.0	43.7	-2.3
	Switch to commitment 4/	50.3	49.3	44.5	-4.9
	Switch to delegation 5/	46.6	46.9	47.4	0.6
REVENUE	Always delegation 2/	...	47.4	48.5	1.1
	Always commitment 3/	...	47.5	47.5	0.0
	Switch to commitment 4/	44.1	45.8	44.4	-1.5
	Switch to delegation 5/	36.2	43.1	45.5	2.4
STRUCTURAL PRIMARY EXPENDITURE 6/	Always delegation 2/	...	45.7	47.2	1.5
	Always commitment 3/	...	47.3	43.0	-4.3
	Switch to commitment 4/	43.8	42.9	40.3	-2.6
	Switch to delegation 5/	42.4	41.2	41.6	0.4
REAL GDP GROWTH RATE	Always delegation 2/	...	2.0	1.7	-0.3
	Always commitment 3/	...	3.7	3.4	-0.3
	Switch to commitment 4/	1.5	3.4	3.1	-0.2
	Switch to delegation 5/	1.5	2.6	2.7	0.1

Source: WEO and staff calculations.
1/ Period: 1980-2003. SGP: 1999-03. Fiscal governance breakdown from Hallerberg (2004). Simple averages.
2/ France, Germany.
3/ Finland, Luxembourg.
4/ Portugal.
4/ Belgium, Netherlands, Ireland, Austrtia, Spain.
5/ Italy, Greece.
6/ Excludes Belgium, Greece, Luxembourg.

174. **A final piece of evidence can be mustered from the stability programs.** SPs are more integrated into the national budget processes of commitment countries (Hallerberg, Strauch, and von Hagen, 2001). Commitment states tend to opt for more conservative forecasts, as parties build in significant safety margins to reduce the likelihood of renegotiation (Strauch, Hallerberg, and von Hagen, 2004). Strauch, Hallerberg, and von Hagen (2004) find an empirical relationship between commitment (and mixed) states and cautious forecasts, controlling for economic factors. This is consistent with what emerges from examining one-, two-, and three- year ahead forecast errors arising from annual SP updates (Tables 7, 8, and 9). First, the absolute value of the forecast error (defined simply as the difference between the outturn and the projection) is lower for commitment states. Second, the difference in forecast errors between the two groups is much larger in the downturn years; delegation states tended to underpredict the size of the deficit dramatically during this period, suggesting overly-optimistic assumptions. Third, the frequency of positive surprises (a higher balance or lower deficit than projected) is far higher among commitment countries. Indeed, during the three bad years (2001-03), not a single delegation or unreformed country experienced a single positive surprise, while it was a fairly common occurrence among commitment countries (see Table 9).

Table 7: Average Absolute Forecast Errors By Forecasting Period, 1999-2003 1/

(In percent of GDP)

	One-Year Ahead	Two-Year Ahead	Three-Year Ahead
All delegation	1.4	2.1	2.3
France	0.9	1.5	2.1
Germany	1.3	2.4	2.5
Greece	1.7	2.2	2.4
Italy	1.1	1.7	1.9
All commitment	0.9	1.4	1.4
Austria	0.4	0.9	1.3
Belgium	0.5	0.7	0.4
Finland	1.1	1.5	1.9
Ireland	1.3	2.3	2.9
Netherlands	2.1	2.8	1.8
Spain	0.2	0.2	0.1
Unreformed	1.3	2.1	2.6
Portugal	1.3	2.1	2.6

Source: Stability Programs and staff calculations.
1/ Based on Stability Programs; excluding Luxembourg.

Table 8. Absolute Forecast Errors for Overall Balance Based on Year, 1999-2003 1/

(In percent of GDP)

Year		Delegation	Commitment	Unreformed
1999	One Year Ahead	0.4	0.8	0.8
2000	One Year Ahead	1.4	1.3	1.3
	Two Year Ahead	1.2	2.1	1.4
2001	One Year Ahead	1.4	1.0	3.3
	Two Year Ahead	1.2	1.2	3.3
	Three Year Ahead	0.9	1.3	3.2
2002	One Year Ahead	1.6	1.0	0.9
	Two Year Ahead	2.4	1.2	1.9
	Three Year Ahead	2.0	0.9	2.0
2003	One Year Ahead	1.5	0.7	0.3
	Two Year Ahead	3.0	1.1	1.8
	Three Year Ahead	3.7	2.1	2.4

Source: Stabilty Programs and staff calculations.
1/ Based on 6 Stability Programs, excluding Luxembourg.

Table 9. Percentage of Positive Forecast Errors, 1999-2003 1/

(In percent)

	Delegation	Commitment	Unreformed
(by forecast period)			
One-Year Ahead	35	63	0
Two-Year Ahead	19	58	0
Three-Year Ahead	0	61	0
(by year)			
1999	100	67	0
2000	75	83	0
2001	0	73	0
2002	0	44	0
2003	0	50	0

1/ Based on 6 Stability Programs; excluding Luxembourg.

175. **Based on current forecasts, the current pattern is expected to prevail into the medium-term** (Table 10). By 2007, all commitment countries are expected to be at close-to-balance, while all four delegation countries, plus Portugal, are not. Moreover, this appraisal is in line with the Council's assessment of the recently submitted 2003 SPs: the delegation and unreformed countries are less likely to reach structural balance before 2006 or 2007, more likely to employ optimistic assumptions, and more likely to breach the 3 percent limit.

F. Reform Options

176. **Notwithstanding the recent procedural impasse, the record on SGP enforcement to date has been reasonably positive, especially for a clear sub-group of member states.** Many countries had clear vested interests in adhering to the targets, and the costs of violating them were non-trivial. Clearly, the preventive arm is crucial: France and Germany would likely have avoided getting enmeshed in the protracted EDP during the downturn had they adjusted earlier. Such self-enforcement was largely absent in delegation states.

177. **It could be shortsighted for the delegation countries not to enforce the agreed fiscal framework given how many members benefit from an external fiscal anchor.** This will become even more relevant as the EU expands, given that most of the accession countries have adopted some form of commitment technology. As many of these countries have large deficits, the importance of an external fiscal anchor is only going to increase. As documented by Ylaoutinen (2004), nearly all central and eastern European countries use some kind of proportional representation in their electoral processes, and rely predominantly on commitment; only Hungary and Slovenia have adopted delegation (see Box 3). Indeed, most of the commitment countries have strengthened their institutions lately, mainly by establishing multi-annual frameworks, possibly in anticipation of the SGP.

Box 3: Fiscal Governance in Central and Eastern European Countries

Bulgaria	Commitment (from 1998)
Czech Republic	Commitment (from 1994)
Estonia	Commitment (from 1994; strengthened 2001)
Hungary	Delegation (from 2002)
Latvia	Commitment (from 1994; strengthened 2001)
Lithuania	Commitment (from 1999; strengthened 2000)
Poland	Commitment (from 1999)
Romania	Commitment (from 1994; strengthened 2003)
Slovakia	Commitment (from 1994; strengthened 2000)
Slovenia	Delegation (from 1994)

Source: Ylaoutinen (2004).

Table 10. Structural Balance Projections, 2003-07

(In percent of GDP)

	2003	2004	2005	2006	2007	Close-to-balance?	Council assessment 1/
Austria	0.1	0.6	-0.5	-0.5	-0.3	Yes	C-t-b in 2004 and 2007; realistic assumptions; no major risk of ED
Belgium	-1.0	0.7	0.5	0.3	0.6	Yes	C-t-b all years; realistic assumptions; no major risk of ED
Finland	2.8	2.6	2.6	3.0	3.4	Yes	C-t-b all years; cautious assumptions; no major risk of ED
France	-2.9	-2.5	-1.9	-1.5	-1.2	No	C-t-b by 2007; plausible assumptions; ED may continue into 2005
Germany	-2.4	-1.9	-1.6	-1.6	-1.6	No	C-t-b by 2007; optimistic assumptions; ED may continue into 2005
Greece	-2.6	-2.7	-2.4	-2.2	-2.0	No	C-t-b by 2006; optimistics assumptions; no major risk of SD
Ireland	1.0	0.6	0.3	0.2	0.3	Yes	C-t-b in 2006; realistic assumptions; no major risk of ED
Italy	-1.4	-2.0	-1.8	-1.6	-1.6	No	C-t-b by 2006; ambitious assumptions; risk of ED
Luxembourg	...	...	...	...	...	...	C-t-b all years; plausible assumptions; risk of ED in 2005
Netherlands	-2.1	-1.5	-1.1	-0.6	-0.4	Yes, by 2006	C-t-b by 2005; some risk to assumptions; risk of ED under adverse circumstances
Portugal	-0.9	-1.8	-1.8	-1.8	-1.8	No	C-t-b by 2007; realistic assumptions; risk of ED
Spain	1.0	1.3	1.2	1.1	1.0	Yes	C-t-b all years; realistic assumptions; no major risk of ED

Source: WEO, Council assessments of Stability Programs.
1/ Based on 2003 updated Stability Programs; c-t-b= "close to balance or in surplus" in line with the SGP; ED= "excessive deficit".

178. **But rebalancing the hard and soft dimensions of the Pact may be necessary.** For soft enforcement at the preventive stage to be effective, a number of conditions need to be satisfied. First, there needs to be political legitimacy and country ownership, which in turns calls for a certain amount of flexibility. Second, there needs to be some cost for non-compliance. Such a cost will be reputational, both within the country and among peers. Peer pressure is most likely to work when driven by the center (top-down) and when a rebuke triggers domestic opposition (bottom-up). Top-down peer pressure will be most effective when the sanctioning body is credible and when there is an even-handed treatment of countries. This form of peer pressure would encompass a more active role for the Commission, which could include the ability to send its own direct early warnings. At the same time, the legitimacy of the dissuasive arm could benefit from more flexibility. In a nutshell, this perspective suggest that the hard aspects should be softened, and the soft aspects hardened.

179. **The challenge is to increase enforceability for the delegation countries while maintaining the external anchor role for the commitment countries.** Against this backdrop, reforms could proceed along the following lines:

- Avoiding procyclical behavior during good times (¶51-52).
- Improving the economic underpinnings of the SGP (¶53-56).
- Increasing reputational costs (¶57-60).

Avoiding Procyclicality in Good Times

180. **To reduce procyclical leakages, countries could be encouraged to strengthen or reform their underlying fiscal institutions.** For a start, countries could adopt the form of fiscal governance most suitable to them. Although often downplayed, institutional reform was a theme in the Maastricht Treaty, which—in its EDP protocol—calls for member states to "ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from the Treaty". In terms of surveillance, there could be a section in the SPs on ongoing institutional reforms, which would then be assessed by the Commission.

181. **Commitment countries in particular could rely on formal rules to stem procyclical pressures to loosen policies in good times.** In this regard, a number of observers have suggested complementing the SGP with national rules such as expenditure ceilings (Mills and Quinet, 2001) or a system of rainy day funds (Buti, Eijffinger, and Franco, 2003). The Commission's staff emphasized the importance of improving expenditure rules and internal stability pacts between central and local governments (European Commission, 2003). These reforms would make the SGP work more symmetrically, ensuring that countries adjust in good times; this, after all, is the heart of the preventive arm. However, these technologies are more suitable for commitment countries, accustomed to more rules-

based frameworks. But even delegation countries might benefit from internal stability pacts with local governments.

Improving Economic Underpinnings

182. **Better economic underpinnings could bolster the Pact's legitimacy, and thus make its enforcement more credible.** Legitimacy is a crucial, often overlooked, component of economic policy coordination in EMU (Hodson and Maher, 2002). Indeed, legitimacy has been elevated by some alongside credibility and flexibility among the most important facets of a fiscal framework (UK Treasury, 2004). In a nutshell, countries will not enforce the SGP if it is not seen as legitimate. States which benefit from an external commitment technology already find legitimacy in the SGP. The challenge is to find the right amount of flexibility in the Pact to make it more legitimate for the delegation states.

183. **How far should the quest for improved economic underpinnings go?** There is a large body of opinion arguing for more flexibility under the SGP, much of it concerned with sustainability issues (see Table 11). The Commission's staff recently tabled a number of ideas, such as tying the medium-term underlying balance target to more country-specific factors, including debt, implicit liabilities associated with aging, and potential growth (European Commission, 2004). Others argue that countries should have complete freedom to set fiscal rules, as long as they are compatible with sustainability (Wren-Lewis, 2003). Many seek more focus on debt (Coeure and Pisani-Ferry, 2003; Calmfors and Corsetti, 2003; Gros, 2003; De Grauwe, 2003). Yet others argue that the SGP should be flexible enough to trade off somewhat higher deficits for other valuable goals such as public investment (Blanchard and Giavazzi, 2003); factor accumulation or growth-enhancing incentives (Padoan and Rodrigues, 2004); or structural reform (Beetsma and Debrun, 2004; Eichengreen, 2003). Although this literature is mainly concerned with the optimality of fiscal rules, it has direct implications for enforceability through the avenue of legitimacy.

184. **But reforms would also need to strive to retain the external anchor needed by commitment countries.** By enhancing political ownership, these kinds of reforms could well make the SGP more acceptable to delegation countries. But some of the more far-reaching proposals could loosen enforcement among commitment countries. Indeed, many of these reform proposals seem designed to tilt the framework towards delegation countries. Also, legitimacy suffers if the proposed modification reduces transparency or accountability. Nonetheless, there could be a role for linking underlying fiscal targets to country-specific fiscal sustainability concerns, all the while retaining the external anchor for commitment countries.

185. **Where does this leave the EDP?** Some observers believe that hard sanctions would become less credible if the SGP became more flexible on the preventive side, as the likelihood of being hit with sanctions diminishes (Hodson and Maher, 2004). However, greater credibility could increase the probability of self-enforcement, while the specter of the ultimate sanction would continue to cast a pall over countries' fiscal policy. At the same time, however, the legitimacy of the EDP is at stake if countries believe it is invoked in an

Table 11. An Overview of SGP Reform Proposals

I. Focus on Sustainability	
General approaches	
Countries which obey their own fiscal rules should be exempt from the EDP, so long as sustainability is guaranteed.	Wren-Lewis (2003)
Initiate a permanent balance rule. Intertemporal tax smoothing approach whereby taxes are set at the minimum value that would satisfy intertemporal budget constraint.	Buiter and Grafe (2003)
Allow for country-by-country articulation of targets to account for such factors as public debt and pension liabilities (within EDP).	Buti, Eiffenger and Franco (2003)
Placing more emphasis on debt	
Initiate a Debt Sustainability Pact. Countries keeping their debt ratios below a certain level (say 50 percent of GDP) would be exempt from the EDP.	Coeure and Pisani-Ferry (2003)
Condition the deficit ceiling on the debt level.	Calmfors and Corsetti (2003)
Countries chose debt targets, and set transition paths by requiring that one twentieth of the difference be eliminated each year.	Gros (2003)
Countries choose debt targets, below 60 percent of GDP. Procedure would be triggered if major deviation from target, or from 60 percent.	De Grauwe (2003)
II. Trading off deficit targets for other factors	
Initiate a "golden rule". Deficit criterion would exclude net government investment.	Blanchard and Giavazzi (2003)
Allow trade-offs between numerical targets and structural reform.	Beetsma and Debrun (2004)
Allow trade-offs between numerical targets and: pension reform, labor market reform, and reform of budgetary institutions.	Eichengreen (2003)
Exclude factor accumulation measures from SGP deficit, and do not allow measures which reduce long-run growth from counting towards the SGP requirement.	Padoan and Rodrigues (2004)
III. Independent fiscal councils	
National fiscal policy committee sets annual deficit targets and is charged with assuring sustainability.	Wyplosz (2002)
National Debt Board enforces upper limit on growth of public debt.	Von Hagen (1998)
Sustainability Council for euro area as a whole replaces numerical targets.	Fatas and others (2003)
Multinational committee charged with establishing whether country had made enough progress in other areas to be exempted from the EDP.	Eichengreen (2003)
National council charged with implementing countercyclical discretionary policy.	Wren-Lewis (2002)
IV. Complementing the Pact	
Introduce expenditure rules to ensure compliance with SGP.	Mills and Quinet (2001)
Improve national fiscal rules, especially expenditure rules and internal stability pacts.	European Commission (2003)
Introduce "rainy day funds" to curb excessive loosening in good times.	Buti, Eiffenger and Franco (2003) Calmfors and Corsetti (2003)

unreasonable way, especially in the midst of a protracted downturn. Hence the drive to reform the multilateral surveillance stage should be accompanied by moves to make the EDP itself more legitimate. In particular, sanctions could be reserved for situations where excessive deficits reflect patent fiscal policy misbehavior. In this light, the definition of "exceptional circumstances" could be re-appraised, and the deadline for correcting the excessive deficit could become less rigid. Indeed, the Commission's staff recently recognized the need for some softening here, and argued for a broader definition of exceptional circumstances and for linking the timetable to such factors as debt and growth (European Commission, 2004).

Increasing Reputational Costs

186. **For peer pressure to work, countries should ideally suffer some loss in reputation.** As noted, the cost of non-compliance can be substantial for a commitment country as fiscal policy loses its anchor. Moreover, the governing coalition itself could break up. Commitment counties, being smaller, also have more to lose from breaching the rules in terms of stature within the EU. Policymakers in delegation countries, especially the larger ones, need not suffer any concrete reputational cost within the country when they breach the SGP.

187. **A growing group of observers believes that a better balance between credibility and flexibility can be reached by passing some fiscal authority to an independent council of experts.** The basic idea is to replace numerical targets ("dead rules") with an independent council ("living bodies"). Such an entity could either be national or EU-wide. On the national level, von Hagen (1998) recommends setting up a National Debt Board, which would enforce an upper limit to the growth in public debt. Wyplosz (2002) also proposes a fiscal policy committee with the authority to set annual deficit targets, with the aim of ensuring debt sustainability. There are also a number of proposals for an EU-wide version of the fiscal policy committee. Eichengreen (2003) calls for a committee to assess whether each country had made enough progress in a number of key areas—such as labor reform, pension reform, and budgetary institutional reform—to be granted an exemption from the EDP. Fatas and others (2003) argue that a Sustainability Council should be established, which would assess the consistency of countries' fiscal plans with sustainability, asking for adjustments if necessary. Enforcement would rely on political pressure through public opinion and financial market reaction.

188. **Within a delegation state, an independent fiscal council could bolster peer pressure, fostering compliance with both arms of the SGP.** Any element of compulsion, however—such as the power to set binding deficit targets—would sit uneasily with the delegation model. Instead, a national watchdog body could monitor fiscal policy against the SGP benchmark, and exercise moral suasion over the government, leading to reputational costs for any violation. In other words, if endowed with enough national credibility to cause the government to lose face domestically in the event of a negative assessment, then it could play a useful role. Independent councils could also help coordinate budgetary policy across different levels of government in countries where local governments possess significant

fiscal autonomy. Along similar lines, Gros, Mayer, and Ubide (2003) suggest that ownership could be improved by compelling governments to testify before their own parliaments following a negative report from the Commission. On the same wavelength, the Commission's staff argued that the dissuasive arm of the Pact could be bolstered if a credible domestic institution—either an independent committee or the national parliament—focused attention on the need for corrective action (European Commission, 2004). Independent councils can also perform a useful role in commitment countries; indeed, Belgium employed this model successfully in the 1990s to bolster its commitment governance mechanism.

189. **Peer pressure should ultimately be guided by the Commission.** Peer pressure from the "bottom up" (country level) could be complemented with "top down" peer pressure, directed by the Commission. The new Treaty would allow the Commission to issue direct warnings to member states, an important step in "hardening" the preventive arm. The Commission could take the views of country-specific independent fiscal authorities into consideration when making its own assessments. Going further and setting up a multinational version of the independent council, endowed with the power to assess fiscal plans and to request adjustment, could overlap too much with the Commission's responsibilities.

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