

THE EU FISCAL RULES: SOME GUIDELINES FOR REFORM*

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1. INTRODUCTION

The recent developments in European Union (EU) public finances and in its multilateral surveillance framework have been adverse. On the one hand, the budget deficits have increased in most member-states, exceeding the 3 per cent of GDP threshold in some cases. Such deterioration is only partially explained by adverse cyclical developments and it appears more pronounced when the effects of temporary measures are excluded. The occurrence of statistical problems and the subsequent revision of the fiscal data reported by some member-states is also a reason for concern. On the other hand, the existing fiscal framework has proved unable to impose sanctions on countries that do not comply with the recommendations to bring the excessive deficit situation to an end. The decision of the European Court of Justice of 13 July 2004, acknowledged that the Council had the authority to ultimately decide on the imposition of sanctions, but it also clarified that its decisions must always be based on the Commission's recommendations, thus revealing a deadlock in the decision process.

Several authors have been putting forward proposals for a substantial reform of the European budgetary surveillance framework, ranging from the introduction of a golden-rule to the creation of

independent fiscal supervision authorities. In many cases, the implementation of such proposals is not feasible because it would represent another change in the EU legal setting just after the signature of the Treaty that establishes a Constitution for Europe. Meanwhile, proposals are being advanced by the European Commission, which has the role of initiating legislation at the EU level, and by some member-states, all of them currently under discussion.

In this paper some guidelines for the reform of the EU fiscal framework are suggested. Overall, they are close to the ones stemming from the Commission's proposals, but with differences in emphasis. The underlying rationale is based on the assumption that the corrective arm of the budgetary fiscal framework will not be fully operative. It is therefore necessary to foster the Commission's ability to assess national fiscal policies, to enhance the statistical framework of the compilation of fiscal data, leading to higher transparency, and to reinforce peer-pressure in the Economic and Financial Committee (EFC) and the Ecofin Council as well as market and public opinion scrutiny of governments' fiscal policies. These proposals are based on the past experience of the EU fiscal framework and take into consideration the existing institutional constraints.

The paper is organized as follows. After this introduction, Section 2 briefly reviews the negotiation process and the set of rules approved before the outset of the European Monetary Union (EMU) and assesses the past performance of the fiscal framework. Section 3 discusses the institutional constraints and the limits to reform. Section

* The views expressed in this paper are those of the authors and do not necessarily coincide with those of Banco de Portugal. All errors and omissions are the sole responsibility of the authors. We would like to thank Maximiano Pinheiro for comments and suggestions.

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4 presents the guidelines for reform in detail. Section 5 summarizes the conclusions of the paper.

2. THE EU FISCAL RULES

2.1 The negotiation process and the final set of rules

The European fiscal framework is a key element in the working of the EMU. The underlying rationale for the existence of fiscal rules is based on the notion that the lack of fiscal discipline puts pressure on prices and this requires, other things being equal, the European Central Bank (ECB) to increase interest rates. Therefore, low-deficit countries would face a cost resulting from the behaviour of countries running high deficits. In addition, in the absence of fiscal rules, pressures would increase on the ECB to accommodate inflationary tensions, as a way to deflate the real value of debt. However, in a context where the ECB is fully independent and price stability oriented, such problem should not exist.

Another argument for the existence of fiscal rules in the EMU relates to the need to avoid fiscal crisis, which would be costly to all member-states. In fact, although the EMU fully eliminates exchange rate risk (facilitating the financing of national fiscal deficits), it simultaneously rules out the possibility of monetary financing of the deficit or the erosion of the real value of public debt through high inflation. The exchange rate risk associated to the national public debt is therefore replaced by a credit risk. The event of a serious fiscal crisis in one member-state, leading ultimately to a default, would pose a dilemma for the EU. If the default materialized, there would probably occur a crisis in the common financial market, and the costs of this would be shared by all the participants in the EMU. In fact, the transmission of such crisis is more likely the more integrated are the financial markets and it is particularly important when public debt plays the role of a stable and low-risk asset in portfolios. Alternatively, if the EU authorities decided to totally or partially “bail out” the member-state facing the fiscal crisis, there would exist costs related with lower credibility and moral hazard. In fact, there would be fewer incentives to fiscal discipline, as countries would anticipate not bearing the full costs of a fiscal crisis.

Taking into consideration these theoretical arguments, the Maastricht Treaty included a set of articles that establish the basis of the European fiscal framework. Article 101 of the Treaty states that the and the national central banks are prohibited from granting credit or acquiring directly public debt. Article 102 states the prohibition of privileged access to financial institutions of the entities that compose the general government. Article 103 exempts the EU and member-states from being liable or assuming the commitments of the general government of a given member-state (the no bail out rule). Finally, Article 104 refers directly to the “excessive deficit procedure”, stating what is considered an excessive deficit and mentioning the existence of reference values for the deficit and the debt ratio (Art. 104-2). It also describes the procedures to be followed in order to decide that an excessive deficit exists in a given member-state (Art. 104-3 to 104-6) and defines the steps associated with the correction of the excessive deficit and the measures to be taken in case of non-compliance (Art. 104-7 to 104-11). Then it sets down the procedure for the abrogation of the decision on the existence of an excessive deficit (Art. 104-12) and establishes the voting procedure together with the imposition on the Council to vote on recommendations from the Commission (Art. 104-13). Finally, the protocol on the excessive deficit procedure mentioned in Article 104-14 and annexed to the Treaty sets the reference values for the deficit at 3 per cent of GDP and the debt ratio at 60 per cent. In addition, Council regulation no. 3605/93 of 22 November 1993 defines the deficit as the general government net borrowing as defined in the European System of Accounts (ESA) and debt as meaning total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government.

The EU fiscal framework set out in the Treaty was incomplete and presented some inconsistencies. The content of the penalties to be imposed on non-complying countries and the specification of what were considered exceptional circumstances, under which countries could surpass the reference values, were vague. Firstly, under Article 104, the exceptions to the reference values comprise situations where the figure for the deficit is declining substantially and approaching the reference value

or a deficit in excess of the latter is regarded as exceptional and temporary. As for the debt ratio, a violation of the reference value is accepted if it is declining substantially and approaching the reference value at a satisfactory pace. Secondly, concerning sanctions, Article 104 mentions that if a member-state fails to comply with the recommendations to put an end to the excessive deficit, the Council can impose a non-interest bearing deposit and, if necessary, decide on fines of an "appropriate size". According to Article 104, the size of the penalties is to be settled by the Council. There are also some inconsistencies in the decision-making process established in Article 104. Firstly, the decision on the existence of an excessive deficit in a member-state is taken by the Council, preceded by an assessment and a recommendation elaborated by the Commission, which should take into account the country's medium-term economic and budgetary perspectives. Indeed, the actions to be taken by the Commission and the Council regarding a decision on the existence of an excessive deficit are not automatic. In addition, as has been made clear by the recent decision by the European Court of Justice, the Council holds the ultimate authority to impose sanctions, but its decisions must always be based on Commission's recommendations. This can lead to a deadlock in the decision process when the opinions of the two bodies are divergent. Moreover, the non-automatism of the sanctioning process compromises the inter-temporal consistency of the budgetary rule. In fact, in the event of a "failure to repent", the Council may feel tempted not to apply sanctions to the member-state concerned, especially if one of the big countries of the EU is at stake. Since the deterrent component associated to the fiscal rules can only be effective if they are perceived as credible, it is clear that the recent developments regarding the excessive deficits in France and Germany have undermined the fiscal framework.

As the outset of the third stage of the EMU approached, a thorough discussion on how the European fiscal framework could be supplemented was launched. In particular, the German authorities argued that a long-term stable community would have to be established if the German public was to be won over to the implementation of the monetary union. Therefore, although not implying additional criteria for the accession to the monetary union,

member-states should make additional commitments so as to ensure a sound fiscal policy in Stage three. The initial rationale was based on the idea that it was necessary to avoid putting an excessive burden on the ECB, which bore alone the responsibility to guarantee price stability. In addition, a more stringent budgetary framework would give a strong signal to the other economic agents, in general, and to the financial markets, in particular, on the commitment of the monetary union to stability.

The German proposals, backed by the Federal Minister of Finance, Mr. Waigel, comprised essentially two points⁽¹⁾. Firstly, the reference value of 3 per cent for the budget deficit as a percentage of GDP should be a ceiling not to be exceeded at any point of the economic cycle. Consequently, countries were expected to follow a medium-term objective for the deficit of 1 per cent of GDP. Exceptions to this objective could only be made in extreme cases and with the approval of two thirds of the countries participating in the monetary union. In addition, the public debt ratio should decline below the reference value of 60 per cent in order to increase the room for manoeuvre in the conduct of fiscal policy. Secondly, proposals for the establishment of an "early-warning mechanism" and for the automatic imposition of sanctions were put forward. In particular, a non-complying member-state would be required to make a non-interest bearing deposit equivalent to 0.25 per cent of its GDP for each whole percentage point in excess of the reference value. The "stability deposit" would be repaid when the country put an end to the excessive deficit, but it would be converted into a fine after two years of non-compliance. Thirdly, the member-states participating in the third stage of the EMU would form a European Stability Council within the Ecofin Council, which would decide on the violation and enforcement of the budgetary rules.

The general ideas underlying these proposals were well accepted by most member-states. The Commission, which holds the right to initiate legislation, developed its own work on these proposals and presented a document entitled "Towards a

(1) For more details on the Waigel proposal entitled "A Stability Pact for Europe" (November 1995) and on the negotiation process, see Brunila et al (2001).

Stability Pact". It argued that a budget in balance or in surplus was a medium-term objective preferable to the 1 per cent of GDP figure referred in the initial German proposal. This opinion was based on an analysis of the semi-elasticities of the national fiscal deficits to cyclical developments. Nevertheless, the Commission argued that, given the different starting points, the medium-term objectives should be adjusted to the specific situation of each country. In addition, the Commission remarked that, according to the Treaty, the decision to apply sanctions to a member-state was assigned to the Council. Therefore, the proposal to turn sanctions automatic required an amendment to the Treaty, which should be avoided, as it would open the door to other changes demanded by different countries. Finally, the Commission considered that the Stability Pact would require closer coordination and monitoring of the national fiscal developments. Therefore, it proposed the yearly presentation of "stability programmes" to be discussed and approved by the Council, specifying the medium-term budgetary targets. Such programmes would bring into the monetary union the successful experience of the "convergence programmes".

Although the document of the Commission was well received, the German authorities did not accept the idea of differentiating budgetary targets according to the countries' specific circumstances and pointed out the importance of implementing automatic sanctions in order to ensure the credibility of the European fiscal framework.

At this point in the negotiating process, other important issues such as the quantification of sanctions and the definition of exceptional circumstances were not settled. At the beginning of December 1996, the Ecofin Council reached a compromise, setting the fine for countries that did not comply with the Council's notice under Article 104-9 at a fixed amount of 0.2 per cent of GDP plus a variable component of 0.1 per cent of GDP for every percentage point in excess of the reference value. The total fine should not exceed 0.5 per cent of GDP. The remaining questions were settled in the Dublin European Council on 12 and 13 December 1996. It was agreed that, apart from the occurrence of events beyond the countries' control, a budget deficit would be regarded as exceptional if a decline in real GDP of at least 2 per cent occurred. In the case of a GDP decline between 0.75

and 2 per cent, the Council would make its own evaluation on a discretionary basis. Finally, the debate on the automatism of the sanctions proved very difficult and it jeopardised the reaching of a general agreement. In the end, it was adopted a draft formula that stated that the Council's decisions regarding the imposition of sanctions would, "as a rule", follow the Commission's recommendations. This was seen as a quasi-automatic mechanism, with relatively tight deadlines for the different steps of the excessive deficit procedure and a presumption of sanctioning in its latter stages.

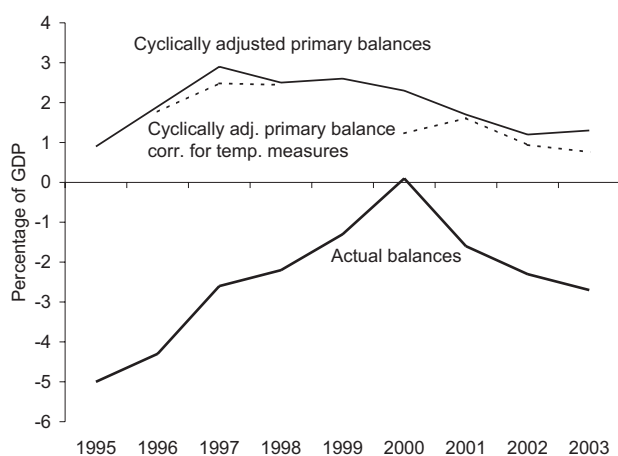
With minor changes, the texts negotiated led to the adoption of the SGP, which took the form of two Regulations and a Council Resolution. Overall, the final text maintained the medium-term objective of a budgetary situation close to balance or in surplus, established the early warning mechanism and set down the assessment of stability programmes to be produced yearly by member-states participating in the third stage of the EMU. Finally, although the amount of the sanctions was clearly defined, their automatic implementation was dropped. On this vital issue it was considered that the SGP included a strong presumption on expected actions to be taken in the event of excessive deficit situations. As recent developments confirm, the absence of automatic sanctions diminishes the credibility of the European fiscal framework and increases the probability of occurrence of deficits higher than the reference value.

2.2 Fiscal developments in the euro area and the performance of the fiscal framework

After the considerable efforts towards fiscal consolidation⁽²⁾ that took place until 1997, aiming at the fulfilment of the Maastricht fiscal convergence criteria, the euro area fiscal position continued to improve until 1999 (see Chart 1). In 1999, the first year of the third stage of the EMU, the fiscal performance was better than anticipated mainly due to developments which enhanced tax receipts, such as a friendly composition of growth, which relied essentially on domestic demand and

(2) Fiscal consolidation is evaluated in terms of the change in the cyclically adjusted primary balance, corrected for the effect of temporary measures - the primary underlying deficit.

Chart 1
ACTUAL BALANCES, CYCLICALLY ADJUSTED
PRIMARY BALANCES AND TEMPORARY
MEASURES IN THE EURO AREA



Source: European Commission. For 1996-98 temporary measures referred in the EMI Convergence Report of 1998 are excluded. For the 1995 and 1999 data not available.

on-going tax reforms that led to unexpected tax receipts in several member-states. In its forecast for 2000, included in the report "Public Finances in the EMU - 2000", following the spirit of the SGP, the European Commission called for further consolidation efforts in order to move member-states closer to balance. Nevertheless, the fiscal outcome was quite different, partly due to the leeway created by sizeable temporary measures. The cyclically adjusted primary balance, corrected for the effect of the sale of UMTS licences (amounting to 1.1 per cent of GDP in 2000) stood at 1.2 per cent of GDP. The implementation of tax reductions in some member-states that were not accompanied by offsetting reforms on the expenditure side contributed to this result. In 2001, the cyclically adjusted primary balance reached 1.7 per cent of GDP. Amidst rising concerns over the path of the European fiscal position, the Ecofin Council endorsed a revised Code of Conduct which also took into account the experience of the first three years of implementation of the SGP. The changes introduced to the previous version of the document⁽³⁾

(3) "Opinion of the Monetary Committee on the content and format of stability and convergence programmes", 21 September 1998, Monetary Committee, European Commission.

consisted in clustering the submission and examination of stability and convergence programmes, improving the quality and comparability of programme contents and presentation, clarifying the definition of the medium-term budget target and the use of cyclically adjusted balances and extending the coverage of programmes to include information on the quality and sustainability of public finances. In 2002, the euro area fiscal position worsened, with the cyclically adjusted primary balance corrected for the effect of temporary measures decreasing by 0.7 p.p. of GDP to 0.9 per cent of GDP. In 2003 the fiscal position deteriorated for the second year in a row, though only slightly. Indeed, the cyclically adjusted primary balance corrected for the effect of temporary measures declined by 0.1 p.p. of GDP. The impact of temporary measures increased from 0.3 per cent of GDP, in 2002, to 0.5 per cent of GDP in 2003.

At this point, two issues deserve further attention. Firstly, despite the unfavourable developments of the euro area fiscal position in the recent cyclical downturn, it is important to compare them with what happened in similar periods of past cycles, as a way to assess the effectiveness of the fiscal framework after the outset of the third stage of the EMU. Secondly, from the institutional perspective, it is important to discuss how the SGP was actually implemented in the context of rising budget deficits in several member-states, exceeding the 3 per cent threshold in some cases.

In the public finance literature, a number of papers run regressions with the objective of explaining the behaviour of the general government deficit. The explanatory variables typically include the output gap, the degree of openness of the economy (Rodrik, 1999), as well as different features of the budgetary procedures and the political and electoral systems (Roubini and Sachs, 1989). In a recent paper focusing on the euro area, Galí and Perotti (2003) regress the deficit, for the period 1980-2002, as a function of the output gap expected in the previous period and the actual deficit and debt ratio observed also in the previous period, using instrumental variables. In addition, a dummy variable is included to capture hypothetical changes in regime after the beginning of the third stage of the EMU. The authors conclude that discretionary fiscal policy in the euro area countries has become more counter-cyclical after 1999.

If this was the case, it might be argued that the current problems arise from an inadequate starting point. At its outset, the SGP faced a fiscal position that was not sufficiently sound to let governments run their desired degree of counter-cyclical fiscal policies without breaching the reference value for the deficit. In fact, the desired degree of counter-cyclical policies may go beyond the normal functioning of automatic stabilizers. Nonetheless, the paper is subject to some criticisms, as it would have been preferable to consider the cyclically adjusted primary deficit also adjusted for the effect of temporary measures as the indicator of fiscal stance. In addition, the inclusion of a wider set of explanatory variables such as the degree of openness of the economy and the level of GDP per capita would have been useful. The IMF, in its 2004 World Economic Outlook, uses a panel analysis to conclude that there is a link between fiscal discretion and procyclicality, suggesting that the EMU's rules-based, discipline-oriented fiscal framework could be expected to improve fiscal behaviour. Nevertheless, a more detailed assessment of fiscal behaviour after 1992 suggests that this improvement could be more apparent than real. In fact, this outcome might result from additional tightness in the good times between 1992 and 1997 motivated by the objective of fulfilling the Maastricht fiscal criteria. The separation of the analysis in two sub-periods reveals that after the outset of third stage of the EMU there was a tendency to loosen fiscal policy in good times whereas fiscal tightening in bad times has disappeared.

As for the issue of how the SGP was actually implemented, the assessment is negative. The deterioration of the fiscal position in several member-states after 2000 led to the triggering of the later stages of the excessive deficit procedure. On 30 January 2002, given the deficits recorded in 2001 and the forecasts for 2002, the excessive deficit procedure inaugurated a new phase with the Commission's proposals to address early warnings to Portugal and Germany. Given the political commitments assumed by the Portuguese and the German authorities, such proposals were not voted on and the debate was closed in the Ecofin Council of 12 February 2002. However, the Portuguese general government accounts for 2001 were revised afterwards. On 24 September 2002, the Commission

released a report, which led, on 11 November 2002, to a Council decision on the existence of an excessive deficit and a recommendation to the Portuguese authorities to bring the deficit below the reference value in 2003 at the latest. Then, on 19 November 2002, the procedure was initiated for Germany, with the Commission's report leading to a Council decision on the existence of an excessive deficit and to a recommendation to the German authorities, both approved on 21 January 2003. In this case, after assessing the draft budget for 2004, the Commission considered that there was no effective action in response to the previous recommendations. As a consequence, on 18 November 2003, it recommended to the Council, under Article 104(9), to give notice to the German government of the need to take measures in order to reduce the deficit until the end of 2005. The procedure concerning France was initiated on 21 January 2003 with the triggering of the early warning mechanism. Then, on 2 April 2003 the Commission issued a report, which gave rise to a Commission recommendation and a Council decision to declare an excessive deficit situation on 7 June 2003. Next, given the unfavourable fiscal developments in France, on 21 October 2003, the Commission elaborated a recommendation for a Council decision under article 104(9). Although initiated at different moments, the German and the French cases were voted on in the Ecofin Council of 25 November 2003, where it was decided not to adopt the Commission's recommendations. Then, on 28 April 2004 the Commission released a recommendation to address an early warning to Italy because the deficit forecasted for 2004 exceeded the 3 per cent of GDP reference value and the reduction of the public debt ratio was coming to a halt. The decision of the Council was postponed from 11 May 2004 to 5 July in order to examine a set of measures to be proposed by the Italian authorities. In the end, the Commission's recommendation was not adopted. The Netherlands was the next country to find itself under the excessive deficit procedure, leading to a Council's decision on 2 June 2004. Finally, on 19 May 2004, the excessive deficit procedure was initiated for Greece, and the recommendation to consider the country in an excessive deficit situation was approved by the Council on 7 July 2004.

Overall, the performance of the early warning mechanism is very poor. In fact, only one out of four Commission proposals was approved by the Council, as the remaining cases were dropped after political commitments assumed by the national governments. In addition, only one out of five excessive deficit situations was preceded by an early warning.

As far as the corrective arm of the excessive deficit procedure is concerned, it is clear that currently it is not fully operative. Firstly, the non-approval of Commission recommendations under article 104(9) for Germany and France led to a substantial loss of credibility for the fiscal framework. Secondly, the European Court of Justice on 13 July 2004, stated that the failure by the Council to adopt the decisions recommended by the Commission is not challengeable, and it simultaneously made clear that the Council cannot modify the recommendations it had previously made to each of those member-states and that only the Commission holds the power to initiate new recommendations. Therefore, the decision process was deadlocked.

It is clear that the EU fiscal framework faces problems with the economic and institutional design of the existing rules and with transparency and availability of fiscal data. Prior to recent developments, taking on board some of these concerns, the Commission made two recommendations public on November 2002. The first one refers to the strengthening of the co-ordination of budgetary policies and includes proposals aiming at improving the interpretation of the SGP and its implementation. The second one concerns the upgrade of the quality of budgetary statistics and justifies the need to create a code of best practices with the objective of increasing the quality, reliability and transparency of budgetary data. Nevertheless, these proposals did not change the existing framework substantially. More recently, in the report "Public Finances in the EMU – 2004", the Commission reinitiated the debate on the guidelines for the reform of the SGP. Then, on 3 September, the Commission made public a communication to the Council and to the European Parliament on "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact".

2.3 Weak statistical standards

Statistical and accounting problems pose a challenge to any rules-based system and the European fiscal framework is no exception. At its outset, it was not made clear that the difficulty in computing, in a reliable and timely way, the key variables upon which the assessment was made would decisively hinder the credibility of the supervision framework. The accounting framework used in the excessive deficit procedure was upgraded from what existed in the past, specifically, with the introduction of ESA-95, the elaboration of the ESA-95 Manual on Government Deficit and Debt and the Eurostat decisions on several statistical issues, but recent experience has been disappointing. As a matter of fact, national authorities retain substantial room to adjust the notified figures if they are not fully committed to fiscal consolidation. As would be expected, these practices arise when the compliance with the budgetary rules is in danger. The situation is aggravated by the fact that, in many cases, the authorities responsible for budgetary management are also those responsible for the compilation of updated public finance statistics for reporting, in a framework characterized by the lack of accountability and the inexistence of penalties for the cases when substantial revisions occur. Finally, there is also no deterrent effect resulting from the possibility of having public finance statistics fully audited by external authorities such as the Eurostat.

The average revision of the general government deficit figures has been sizeable for some member-states and the revisions that increase the deficit are more frequent than revisions that reduce it. Some significant revisions were those of the Portuguese deficit for 2001, from 2.2 to 4.1 per cent of GDP, which took place in 2002, and those of the Greek deficit from 2000 to 2003, representing an average revision of 2.4 percentage points in each year, which took place in 2004. In addition, the existence of permanent positive deficit-debt adjustments in countries in deficit and with large debt ratios may also be a symptom of statistical problems. The average deficit-debt adjustment in the period 1994-2003 in the EU15 amounted to 0.4 per cent of GDP, but it reached much higher values for some member-states. Some examples are those of Greece, Austria, Portugal and France, with aver-

age deficit-debt adjustments in the period 2000-2003 of 3.7, 0.9, 0.8 and 0.8 per cent of GDP, respectively.

In most cases, the less adequate compilation of fiscal figures does not imply a formal violation of the accounting rules (ESA-95). However, in some countries where the prescriptions of the ESA-95 were not respected, sizeable revisions were imposed by the European institutions or decided by newly elected governments, which did not want to bear the responsibility for past wrongdoings. One area where statistical problems have been identified is the consistency of cash and accrual accounting, for example, on the recording of tax revenues, which may be adjusted to benefit the revenues of one specific year. The recording of transactions with financial assets and the delimitation of the general government sector is also a source of statistical problems. For example, some capital increases made to public corporations are not actually financial operations as they are used to finance chronic losses.

Another important aspect related with weak statistical standards concerns the utilization of temporary measures to positively affect the deficits. In these cases what is at stake is not a less adequate compilation of fiscal figures but instead the utilization of statistical regulations loopholes in order to have a positive impact on the deficit. An example of this is the sale and lease back of government buildings, which generates more revenue at the expense of future payments with rents. These problems date back to the poor statistical standards accepted in some of the 1997 Convergence Reports, but they are currently becoming increasingly important.

3. INSTITUTIONAL CONSTRAINTS AND THE LIMITS TO REFORM

The reform of the European fiscal framework is a very difficult task, on institutional and political grounds. The overall budgetary rules are set in the Article 104 of the Treaty that establishes the EU, and it constitutes primary legislation. Therefore, it was agreed by direct negotiation between member-state governments and it was subject to ratification by national parliaments. Council Regulation n° 3605 of 22 November 1993, which set down the exact definition of the relevant aggregates accord-

ing to the ESA classification as well as Council Regulation n°1467/97 on the speeding up and clarifying the implementation of the excessive deficit procedure, are based on paragraph 14 of Article 104 of the Treaty, where it is said that "The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the ECB, adopt the appropriate provisions which shall then replace the said Protocol". Any possible changes therefore require unanimity of member-states.

At present it is clear that any amendments to the Treaty are not feasible as a new integrative constitutional text has been recently signed by the member-states. The new provisions included in the Draft Constitution concern the existence of "early warnings" directly issued by the Commission and the launching of the excessive deficit procedure based on Commission proposals rather than recommendations. These provisions increase the ability of the Commission to exert peer-pressure on fiscal issues but they are not sufficient to overcome the problems of the fiscal supervision framework.

Unanimity is very difficult to find in the EU Council, especially now in its enlarged version with 25 countries. Firstly, countries currently in an excessive deficit situation would not approve changes that imply the effective implementation of sanctions. As a matter of fact, the implementation of sanctions could only come through an automatic system or through the attribution of decision power to the Commission on this matter. Both alternatives are unrealistic. The principle of automatic sanctions is perfectly acceptable and even desirable in economic terms as it fully ensures the credibility of the fiscal framework and eliminates the intertemporal inconsistency problems. Nevertheless, as we mentioned in the second section, this issue was a major focus of debate during the SGP negotiations and it was not possible to reach a consensus at that time. Alternatively, the attribution of decision power to the Commission to implement sanctions on non-complying countries would certainly face the opposition of many member-states. As a matter of fact, the balance of powers in the EU gives no supremacy to the Commission over the Council. According to the Treaty, the Commission is the initiator of proposals for legislation, the guardian of the Treaties and the man-

ager and executor of EU policies and of international trade relations. However, it does not take any decisions on EU priorities and policies, as this is the prerogative of the Council and, in some cases, also of the European Parliament. Secondly, countries that have recently acceded to the EU would presumably oppose any changes in the fiscal framework that made their future accession to the monetary union more difficult. Finally, explicit changes to the legislation that sets down the fiscal framework, concerning specific aspects, such as giving more importance to the public debt ratio or the consideration of long-term fiscal projections, such as those associated with the financing of public pension systems, would predictably face the opposition of the countries where such problems are more acute.

Alesina and Perotti (2004) discuss the voting rules and the institutional design of the EU. In their view, they are characterized by lack of clarity in the allocation of powers between European institutions, confusion in the allocation of prerogatives between national governments and EU institutions and lack of transparency, making it more difficult to reform of the European fiscal framework. Therefore, despite being theoretically interesting and potentially desirable in practice, many of the proposals put forward in several papers published during the last years cannot at the moment be implemented. These proposals are numerous and it is impossible to list them here. They broadly range from the adoption of a golden rule or an expenditure rule (Fitoussi and Creel, 2002 and von Hagen, 2002), to the creation of an independent experts fiscal policy committee (Fatás et al, 2003) or the move to a debt sustainability pact (Pisani-Ferry, 2002).

Given the existing difficulties in reaching a consensus on the reform of the European fiscal framework, some argue that it is preferable to leave it as it is. Firstly, despite its problems, the existing framework has achieved some positive results, such as the existence of a well-known and publicly scrutinized reference value for the budget deficit, which helps to frame governments' fiscal policy decisions. Secondly, during a long negotiation process, the existing framework would lose further credibility. Thirdly, there is the risk that the negotiation would lead to a less stringent fiscal framework, potentially acceptable to all countries. The

loosening of the fiscal framework could come through changes in the definition of the relevant indicators, notably, the definition of the general government deficit. Further loosening could come through a redefinition of the exceptional conditions under which deficits higher than 3 per cent are allowed or of the timing for the correction of excessive deficit situations. As a matter of fact, if different motivations lead member-states to unanimously agree on the withdrawal of different expenditure items from the deficit calculations, for instance military expenditure, transfers to the EU budget or I&D expenditure, the underlying fiscal framework will become inoperative in practice.

At present, the process of reform of the EU fiscal framework is evolving in various directions. The European Commission has been fulfilling its role as initiator of proposals for legislation, which will be later evaluated by the Ecofin Council. The guidelines proposed by the Commission were outlined in the report "Public Finances in the EMU 2004" and developed in the Commission's communication on "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact" of 3 September 2004. The proposals aiming at refocusing the Pact involve placing more focus on debt sustainability, allowing for more country-specific circumstances in defining the medium-term objectives, considering economic circumstances and developments in the implementation of the excessive deficit procedure and ensuring earlier actions to correct inadequate budgetary developments. The proposals aiming at improving coordination of policies imply a stronger connection between the Broad Economic Policy Guidelines, the updates of the stability programmes and the national budgets. Finally, strengthening of the enforcement of fiscal rules would result from the increased quality, timeliness and reliability of budgetary statistics and greater transparency and accountability regarding national fiscal policies. In parallel, other proposals are being advanced by several member-states. Some of them go much beyond the Commissions' proposals and actually make reference to the exclusion of certain expenditure items from the calculation of the general government balance.

The authors believe that it is possible to improve the existing fiscal framework within the existing institutional limitations, ensuring no further

loss of credibility and maintaining the main messages that have been passed to public opinion regarding the need for fiscal co-ordination in the EU. The underlying rationale is based on the principle that, given the institutional restrictions, the corrective arm of the fiscal framework will not be fully operative. However, there is room to enhance the preventive component of the fiscal framework, through the improvement of the Commission's ability to evaluate national fiscal policies, the reduction of the statistical problems associated with fiscal data, leading to higher transparency, and the reinforcement of peer-pressure as well as market and public opinion scrutiny on governments' fiscal policies. The main guidelines for reform are discussed in detail in the next section. These guidelines are close to the ones presented by the Commission but with differences in emphasis.

4. GUIDELINES FOR REFORM: A DISCUSSION

As previously discussed, the EU Commission should be able to ensure a thorough evaluation of the fiscal situation of member-states and flag either deviations from what is considered an adequate and sustainable fiscal path or any shortcomings related with the quality and transparency of the statistical information that is provided. The fulfilment of such a role in the EU fiscal framework should allow the right peer-pressure and public scrutiny, encouraging governments to keep public finances on a sustainable path. In this context, the technical quality and transparency of the analysis carried out by the Commission is vital. In fact, the higher its credibility, the stronger its impact on decision-making in the EU institutions and on markets and public opinion.

Any proposal for reform must also fulfil certain specific requirements. Firstly, the economic rationale underlying the proposals must be incentive-compatible, otherwise its effectiveness will be reduced. Secondly, the rules and the fiscal objectives should be both implementable and realistic. The setting of overly ambitious objectives is frequently the first step towards no adjustment at all. Thirdly, the rules should be simple in order to enhance the scrutiny from markets and public opinion. Finally, it should not require major amendments to the main legal texts. The guidelines for

reform presented below try to fulfil these requirements.

4.1 Medium-term fiscal objective

One of the important contributions of the SGP to the European fiscal framework was the definition of a medium-term objective for the budgetary situation of member-states, which should be close to balance or in surplus. According to the resolution of the European Council on the Stability and Growth Pact of 17 June 1997: "Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3 % of GDP."

More recently, this objective has been evaluated on cyclically adjusted terms⁽⁴⁾ and does not differentiate the specific circumstances of member-states regarding key variables, such as, the sensitivity of the fiscal balance to the output gap, the growth rate of potential output, the public debt ratio, the amount of contingent or implicit liabilities related to government guarantees or the future payment of pensions.

This approach raises some criticisms. Firstly, the current methodology for the calculation of the output gap, which is later used for the calculation of the cyclically adjusted fiscal balance, is not easily reproducible by other entities⁽⁵⁾. In fact, its relative complexity leads to a lack of transparency, which diminishes the public impact of the Commission's analysis. In this case, the trade-off between technical requirements and transparency should be reevaluated, developing a simpler method, easily understandable by the experts

(4) The reference to the evaluation of the medium-term objective in terms of cyclically adjusted balances dates back to the revised Code of Conduct of July 2001. Later, in October 2002, the Eurogroup meeting referred that the correction of fiscal imbalances should be based on the underlying balance, considered as the balance adjusted for the effect of cyclical developments and temporary measures. In March 2003, the Ecofin council stated that such correction should be evaluated in cyclically adjusted terms and temporary measures would be considered case by case on their own merits.

(5) The methodology used by the European Commission for the calculation of the cyclically adjusted balances is based on a production function and the OECD semi-elasticities of the fiscal balance relatively to the output-gap.

Chart 2A

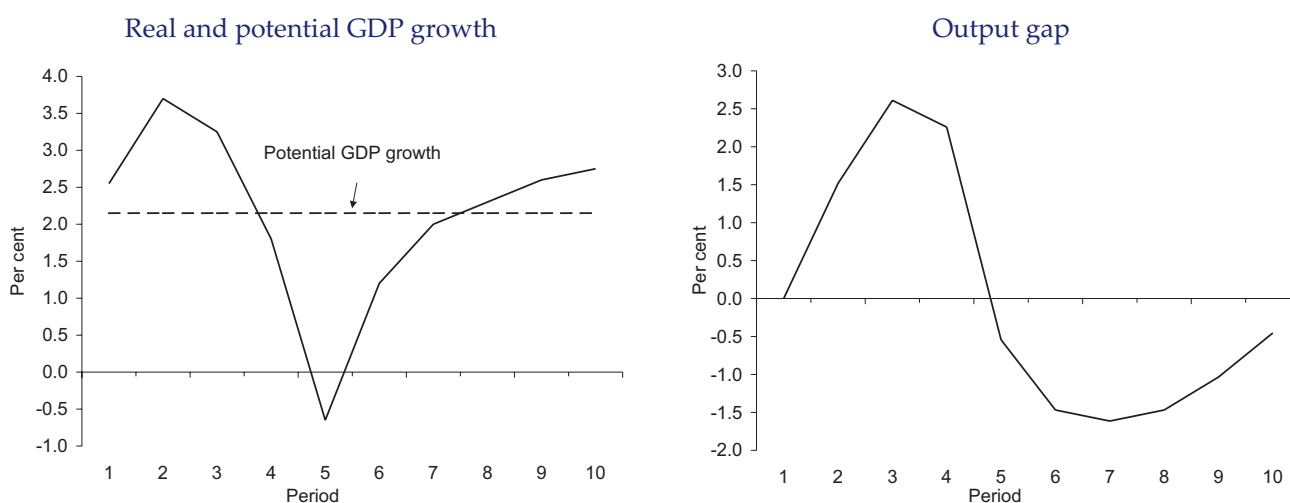
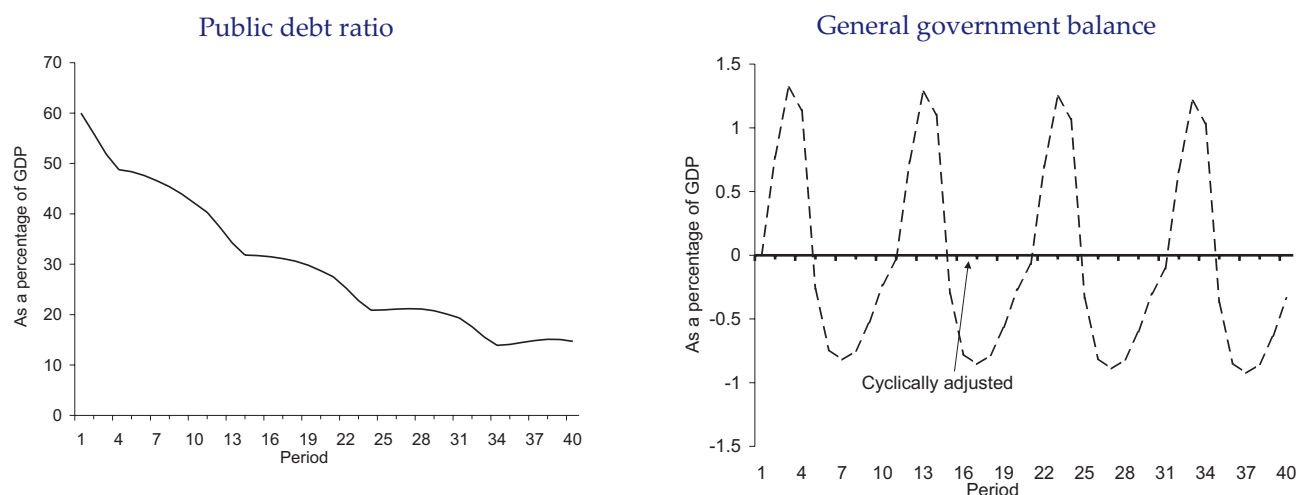


Chart 2B

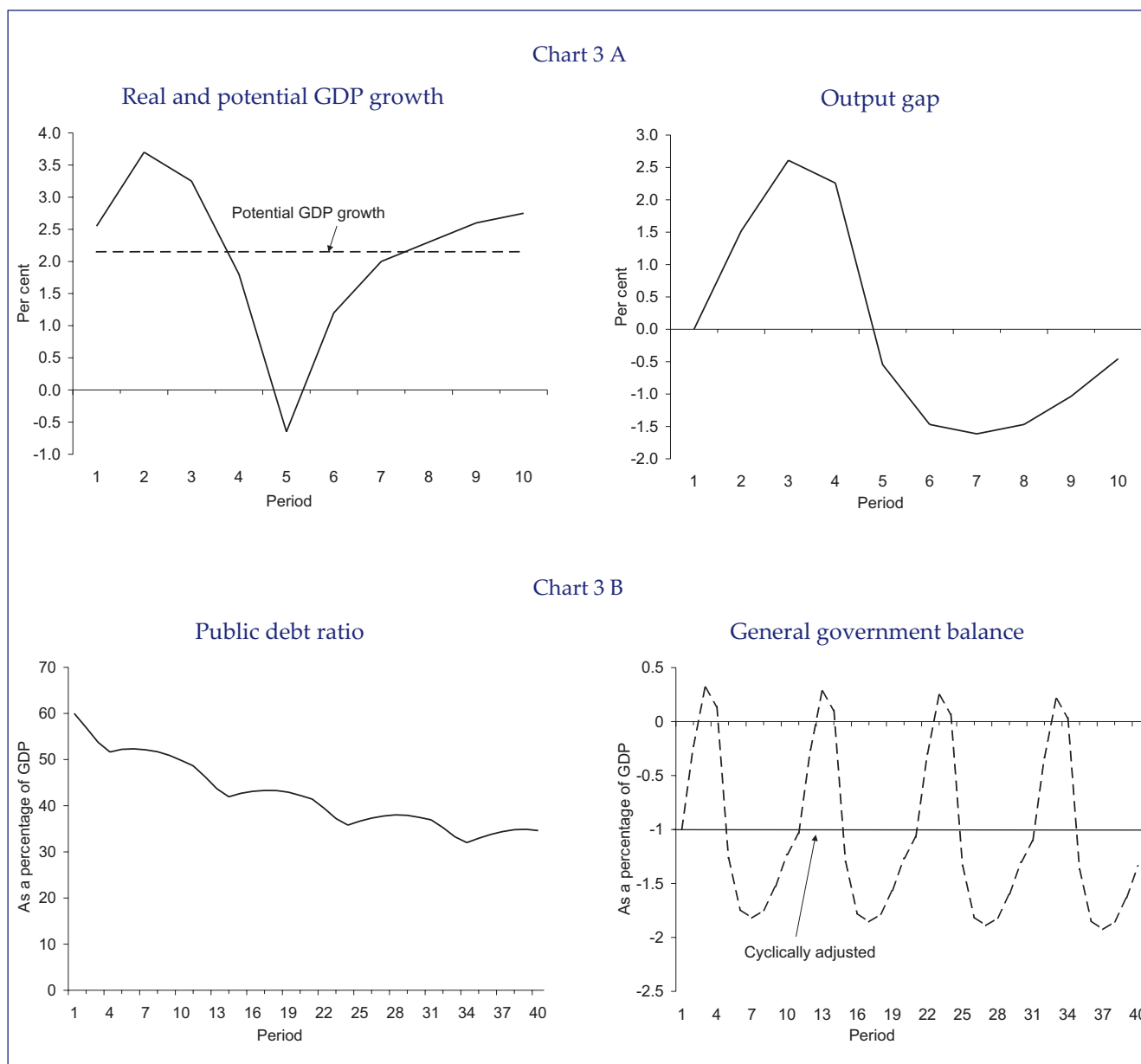


from domestic and international institutions and the public in general. For example, the potential

(6) The simulated economic cycle takes an average real GDP growth and a standard deviation equal to the simple average of what was observed in the last two economic cycles in the euro area (1981-1992 and 1993-2002). The two parameters are respectively 2.2 per cent and 1.2, respectively. Inflation is set at 2 per cent. The objective of the simulations presented is merely illustrative. The consideration of averages does not allow for the evaluation of worst-case scenarios, where the average real output growth is low and its volatility is high in the economic cycle. In this simple framework, it is also important to note that in situations when there is a sharp change in the debt ratio, the decline in interest expenditure facilitates the reduction of the overall deficit, though not leading necessarily to fiscal consolidation, since this one is evaluated through the change in the primary balance or the underlying primary balance.

real GDP growth rate could simply be the average real GDP growth rate observed during the last economic cycle (i.e. the moving average of the last ten years), to be coupled with a semi-elasticity on the fiscal balance to be provided by each country, under the technical scrutiny of the European Commission, and to be maintained fixed during a given number of years.

Secondly, the aforementioned medium-term objective of close to balance or in surplus seems too restrictive for countries with low public-debt ratios and low cyclically adjusted deficits. Taking as a rough and merely illustrative example the average EU business cycle (presented in charts 2A-5A and successively repeated to generate the underlying scenario for Charts 2B-5B)⁽⁶⁾, the de-



parture from a debt-ratio of 60 per cent, together with a constant zero cyclically adjusted balance, puts the debt ratio on a diminishing path, reaching about 15 per cent in forty years (Chart 2B). This is an undesirable outcome as public bonds, which are regarded as non-risk assets, play a vital role in the stability of international financial markets. Therefore, a more neutral long-term objective should be set. Given the parameters of our illustrative example, a cyclically adjusted deficit of 1 per cent would smoothly reduce the debt-ratio to close to 40 per cent in about 20 years (Chart 3B). A debt-ratio of 40 per cent is perceived as a prudent figure, giving room for an increase of debt if an adverse fiscal shock occurs.

Thirdly, the consideration of different medium-term objectives according to the member-states' debt ratio is warranted. It is clear that a country that records high initial debt levels and high cyclically adjusted deficits is on an unsustainable path. In such cases it would be useful to define a transition period along which improvements in the cyclically adjusted balances would be imposed on a yearly basis, until a sustainable fiscal situation is achieved. In Chart 4B we illustrate this situation considering the previous illustrative business cycle, with a cyclically adjusted deficit of 2 per cent, an initial debt ratio of 100 per cent and a 4-year adjustment period (a consolidation of 0.5 p.p. of GDP each year) until a balanced cyclically adjusted situation is achieved. In this case, the

Chart 4 A

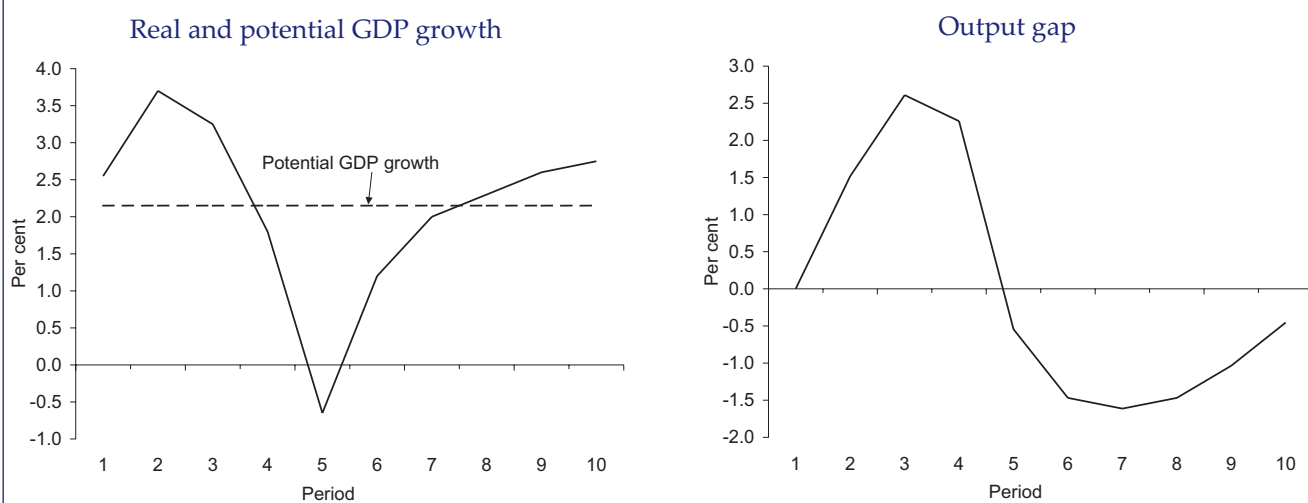
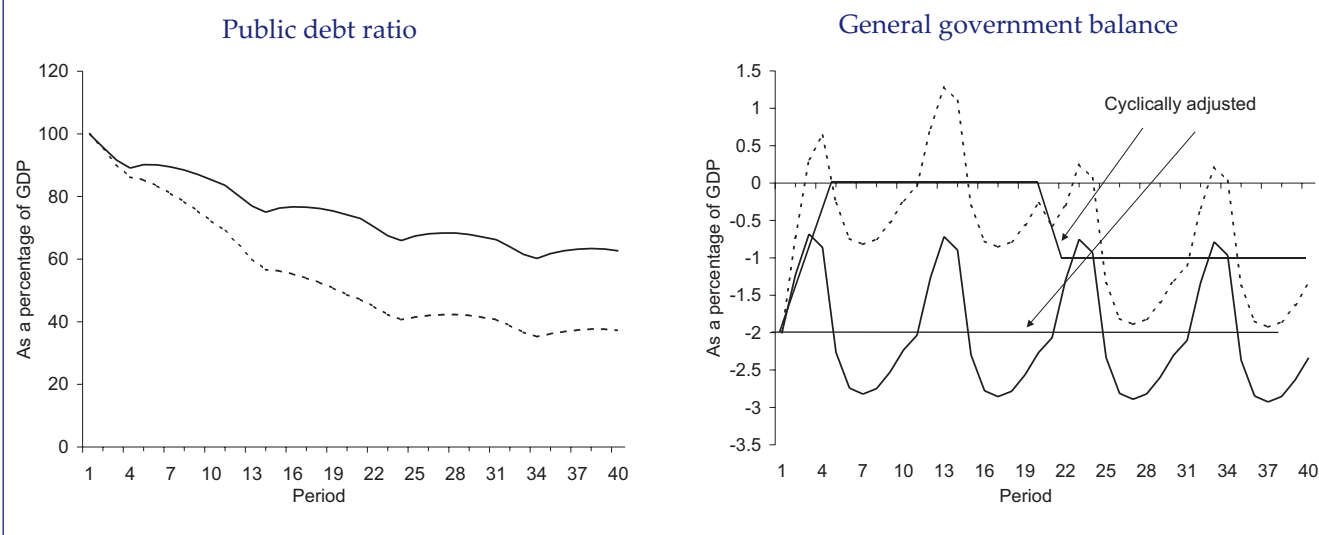


Chart 4 B



debt ratio would move to a prudent level of 40 per cent in about 20 years (dashed line). After that period, the stabilization of the debt ratio would be achieved through a lower cyclically adjusted balance. Alternatively, member-states with low initial debt levels (for example 40 per cent) but high cyclically adjusted deficits (for example 3 per cent of GDP), also tend to face rising public debt ratios (Chart 5B). In this case, it is necessary to stabilize the public debt ratio, which, in our example, would come through a 4-year adjustment period (consolidation of 0.5 p.p. of GDP each year) until a 1 per cent cyclically adjusted deficit is achieved.

Finally, it is important to underline that other factors determine the path of the general government balances and public debt ratio. Firstly, the ex-

istence of contingent liabilities, which are backed by legal obligations but may never lead to government expenditure, and implicit liabilities, which are not currently accounted but are likely to translate into higher expenditure in the future, may strongly affect the fiscal position. In particular, the widely discussed phenomenon of ageing determines important implicit liabilities to governments through higher future expenditure with pensions in pay-as-you-go systems. Therefore, any reform to the EU fiscal framework should address this problem. As previously mentioned, a possible solution is to impose a path for the cyclically adjusted balance that implies a reduction of the debt ratio to a prudent level, in order to provide a cushion for the higher expected public indebtedness

Chart 5 A

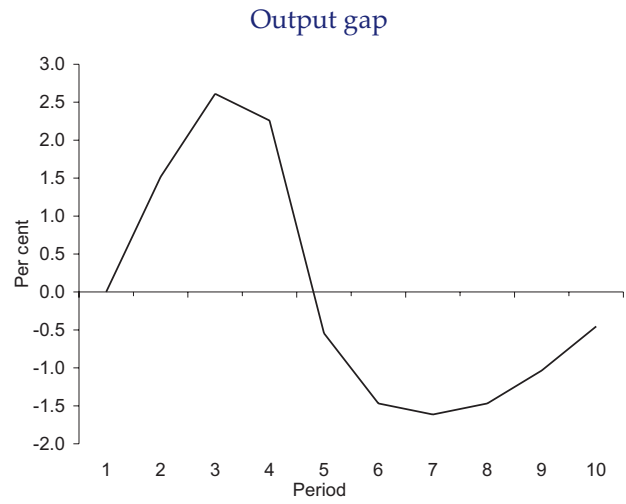
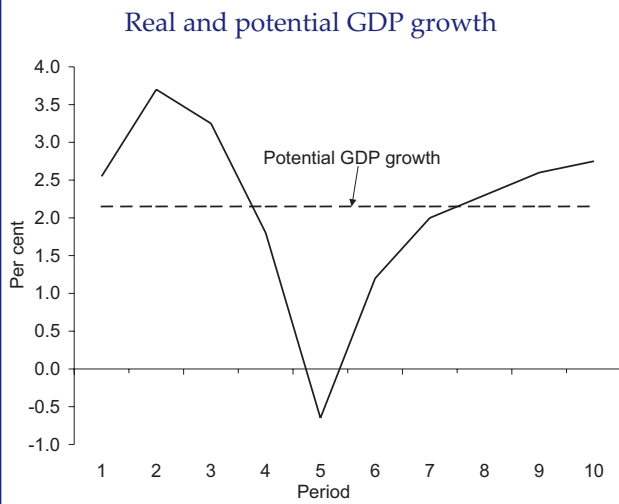
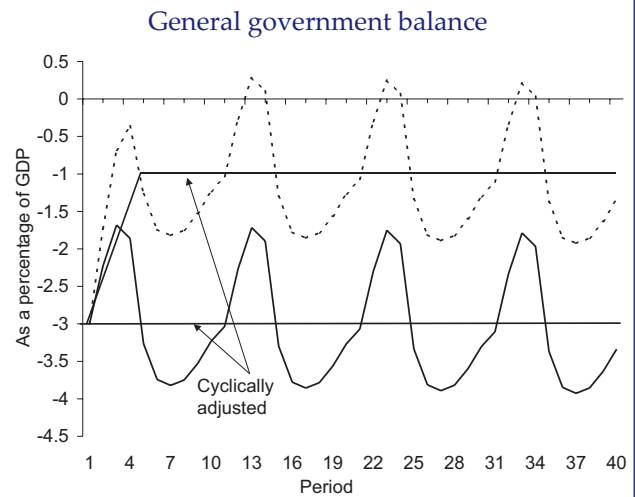
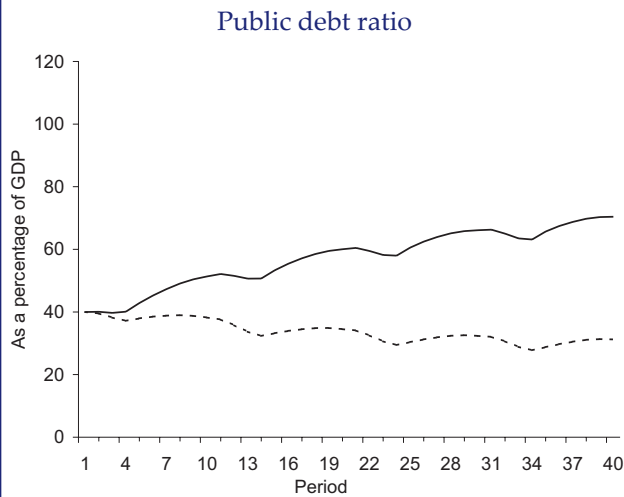


Chart 5 B



during the period when the impact of ageing becomes more acute. The difficulty in assessing the projections for additional expenditure resulting from ageing, which are presently not fully comparable between member-states, recommends the consideration of a common safety margin. In this context, only grounded on solid evidence would it be possible to exempt a member-state from building such a safety margin.

The other element that severely distorts the evaluation of fiscal developments is the use of temporary measures that affect the general government deficit. The effect of these measures, which are being used in a growing number of countries and on a repeated basis⁽⁷⁾, should not be considered in the computation of the general gov-

ernment balance relevant for the assessment of fiscal developments. It is worth mentioning that temporary measures comprise one-off measures, which have effects only on the deficit of the current year, and self-reversing measures, which benefit the deficit of the current year but also burden future deficits. This latter type of operation is particularly undesirable as it implies higher future implicit or explicit liabilities. A deterrent for the utilization of this type of operations on the part of member-states is to correct their effects through the calculation of the underlying balance.

(7) See details in the report "Public Finances in the EMU, 2004", European Commission.

In theory, the consideration of exceptional circumstances is partly inconsistent with the credibility of a rules-based system. Nevertheless, in practice, such provisions are required and they were included in the EU fiscal framework. In this field, three main guidelines should be taken into account. Firstly, the exceptional circumstances in terms of differences between actual and required budget balances should be based on relative deviations from the macroeconomic scenario considered in the budget⁽⁸⁾. Secondly, for the case of countries with prudent debt levels and close to balance, a counter-cyclical fiscal stance, i.e. a lower primary cyclically-adjusted balance corrected for the effect of temporary measures, could be accepted, even if this means actual deficits higher than the 3 per cent of GDP threshold, if in the preceding good periods of the cycle the medium-term objective was overachieved, i.e. "rainy days surpluses". This would create incentives not to adopt an expansionary fiscal stance in the good phase of the cycle. Finally, for the group of countries experiencing fiscal imbalances, during the transitory adjustment period, consolidations exceeding 0.5 per cent of GDP per year during good times would give a margin for lower adjustments during low growth periods. This would give an incentive for bigger adjustment in good times.

Overall, a revision of the yearly and medium-term fiscal objectives based on the cyclically adjusted balance and corrected for the effect of temporary measures is advocated. The medium-term objective should lead member-states to a situation where the debt ratio is stabilized at a prudent value and the actual balances do not surpass the 3 per cent of GDP reference value in the lower part of the cycle. The adjustment for the effect of ageing on pension expenditures should be uniform between countries, justifying the creation of a safety margin for the debt ratio, with possible exemptions for countries that present solid evidence of no future pressures on pension expenditure. Furthermore, the computation of the cyclically adjusted balances should be clear and easily computable by other entities and economic agents. The

differentiation of countries' fiscal adjustment should take into consideration the underlying balances and the public debt ratio, demanding a stronger temporary adjustment for those with higher imbalances and more indebted. The adjustment period should be clearly defined and realistic. Finally, it should be noted that the adoption of this set of rules, which objectively differentiate the fiscal situation of member-states, does not raise questions related to an unequal treatment. The crucial element is to ensure the transparency of the process and a common set of procedures.

Although it is important to evaluate the fiscal position of member-states according to their specific circumstances, the degree of discretionarity in the analysis must be reduced as much as possible. In this context, to take into consideration the future positive effects of announced structural reforms in the assessment of the fiscal position is problematic. The argument for the consideration of the future effects of structural reforms on the fiscal assessment and in the definition of the medium-term budgetary targets is based on the belief that such reforms imply short-term budgetary costs, either due to higher expenditure or lower receipts. Thus, if countries are constrained by tight fiscal rules, they will not be able to implement such reforms, forgoing their positive medium and long-term effects, in particular on real GDP growth. The argument runs for social security reforms, tax reductions, labour and product market reforms and additional investment expenditure. Thus, according to this interpretation, the consideration of the future effects of such reforms on the present fiscal assessment would free the SGP from undesirable constraints and would make it "growth-friendly".

The theoretical validity of these arguments depends on the type of structural reform considered. In any case the past experience is not reassuring. Firstly, there is no motive to consider reforms that do not imply substantial increases in expenditures, such as labour and product market reforms or changes in pension system eligibility criteria. In these cases, the existence of fiscal rules does not pose an obstacle to its implementation. Secondly, allowing for higher deficits due to lower taxation would only be acceptable if its future effects on GDP increased receipts by a similar amount. Nevertheless, the effects of tax reductions on GDP are

(8) In Sub-section 4.2 it is highlighted the need to consider realistic macroeconomic scenarios in the elaboration of national budgets, for instance by using the Commission's Spring forecasts as a baseline.

disputable and the Laffer-curve effects lack empirical validation. Thirdly, allowing for deficits due to additional public investment is basically equivalent to adopting a golden-rule. The argument is theoretically valid but there are serious practical problems that impair its implementation, in particular, the identification of the transactions that should be classified as investment and the evaluation of its quality and impact on future GDP growth. Finally, allowing for higher deficits due to the implementation of a pension reform based on a multi-pillar system seems acceptable. Such a reform is relatively easy to assess and there are clearly positive effects on the sustainability of public finances. This is the only case where it seems uncontroversial to consider the costs of a structural reform for the effect of both the choice of the medium term target and the analysis of a violation of the 3 per cent threshold.

It is also worth noting that the recent deterioration in the fiscal position of several member-states is not clearly attributable to the short-term costs of ongoing structural reforms or to higher public investment. Taking the cases of Germany, France and Italy (Table 1) it seems that there has been a reduction in taxation in the recent period that has not been offset by a similar decrease in primary current expenditure. As for the cases of Portugal and Greece, the increase in the tax revenue has been much lower than the increase in current primary expenditure. In addition, with the exception of Greece, public investment has not significantly increased in the recent period. Therefore, in the light of past experience, arguing for a more "growth-friendly" SGP means allowing for lower taxation as a percentage of GDP, whose impact on public finances is permanently negative and with an uncertain effect on GDP growth.

4.2 Timing of the budgetary process and institutional features

The organization of budgetary procedures, such as the negotiation process in the elaboration of the budget, the timings and the voting rules, are acknowledged as important determinants of fiscal performance (see for instance von Hagen, 1992). In the EU, the design of fiscal policy and of the national budgetary procedures is the responsibility of member-states. Nevertheless, given the ineffec-

Table 1
AVERAGE TAX REVENUE
% GDP

	1996-2000	2001-2003	Dif
Portugal	35.2	36.1	0.9
Germany	42.7	41.3	-1.4
France	45.9	45.1	-0.9
Italy	42.9	41.8	-1.1
Greece	37.1	38.5	1.5

AVERAGE GOVERNMENT INVESTMENT
% GDP

	1996-2000	2001-2003	Dif
Portugal	4.1	3.7	-0.4
Germany	1.9	1.7	-0.3
France	3.1	3.2	0.1
Italy	2.3	2.3	0.0
Greece	3.5	3.8	0.3

AVERAGE CURRENT PRIMARY EXPENDITURE
% GDP

	1996-2000	2001-2003	Dif
Portugal	34.8	38.4	3.6
Germany	41.7	41.7	0.0
France	45.1	45.0	-0.1
Italy	37.7	38.7	0.9
Greece	32.8	35.2	2.4

Source: European Commission. For Portugal, data corrected for the effect of temporary measures in 2002 and 2003.

tiveness of the corrective arm of the budgetary surveillance framework, it is crucial to increase the ability of the Commission to put pressure on national governments in order to conduct appropriate fiscal policies, in particular, through the effect of its assessments on the decision-making process in the EFC and the Ecofin Council and on the scrutiny of public opinion and financial markets.

In this context, changing the timings of submission of some documents that currently determine fiscal policy decisions in EU member-states would bring significant benefits. The current framework is based on four elements. Firstly, in April the Commission makes public the Broad Economic Policy Guidelines, which has a multi-annual perspective, containing both general and country-specific recommendations, laying down the EU's medium-term economic policy strategy. Sec-

(9) The content and the timing of submission of the Stability and Convergence Programmes were revised in the new Code of Conduct, adopted in July 2001.

ondly, in the third quarter of the year, member-states elaborate national budgets, which are approved in general in the fourth quarter. Thirdly, in principle, before the 1st of December of each year, countries submit the stability and convergence programmes containing medium-term information on the path of the main public finance indicators, some analysis on the quality of public expenditure and long-run projections for pension expenditure⁽⁹⁾. Finally, the programmes are assessed by the Commission and discussed by the EFC and the Ecofin Council. Therefore, the Commission's assessment on each country fiscal developments does not influence the elaboration of the national budgets. The submission of member-states' stability programmes and their subsequent assessment by the Commission, EFC and Ecofin Council should occur before the approval of national budgets in order to provide a relevant input to the national debate. In addition, in order to avoid the temptation to be overoptimistic on macroeconomic assumptions, as a way to facilitate the construction of a softer fiscal scenario, the change in the timing of submission of the stability and convergence programmes should be accompanied by the obligation to use the Spring Economic Forecasts of the Commission as the baseline macroeconomic scenario. Nevertheless, there would be some time lag between the submission of the stability programme and the elaboration of the national budget, which means that new relevant information might become available. In this context, in the elaboration of the budget, deviations from the baseline scenario would have to be explained by national authorities strictly on technical grounds.

The proposed procedure would bring some benefits but it does not necessarily guarantee the approval of an adequate budget at the national level. The member-states ultimately retain the ability to define their fiscal policy and as in the past they may easily argue that the positive effect of projected reforms is higher than forecasted by the Commission. Therefore, it would be useful to maintain the assessments of fiscal policies after the approval of the national budgets. These assessments could be elaborated by an independent expert committee and made public at the beginning of each year. The creation of this type of committee has been advocated by some authors (see for ex-

ample Fatás, von Hagen, Hallett, Strauch and Sibert, 2003) as providing a more flexible analysis, independent from short-term political pressures and focused on fiscal sustainability. In the present EU institutional framework, it is difficult to conceive that such a body would hold the power to ensure fiscal sustainability at the national level, not to mention the ability to determine any type of sanctions. Nonetheless, a small fiscal expert committee could assess national budgets, acting, in the perspective of public opinion and financial markets, as an independent third party, which reinforces the pressure on governments to adopt sustainable fiscal policies. Such a body should also adopt a pedagogical approach, informing public opinions on the importance to ensure fiscal sustainability as a way to foster growth and social cohesion.

4.3 Improving the statistical system

As mentioned above, the experience of the EU rules-system has been somewhat poor in terms of the quality, timeliness and reliability of public finance statistics, and this impairs the credibility of the fiscal framework.

The areas where most statistical problems have been identified are the consistency of cash and accrual accounting, the recording of transactions with financial assets and the delimitation of what constitutes the general government. According to ESA-95, the general government accounts should be compiled on an accrual basis, that is, expenditure and revenue should be recorded at the time of the underlying transaction, irrespective of the timing of effective cash payments and receipts⁽¹⁰⁾. The main argument against the use of cash based accounting for budgetary surveillance purposes is related with its volatility, as payments and receipts associated with expenditure and revenue are in many cases subject to an erratic temporal pattern. Nevertheless, accrual accounting tends to be more complex to implement in a transparent way and it is much more difficult to audit. Therefore, it seems

(10) However, according to Regulation n°251/2000, tax and social contribution receipts may also be recorded on a cash adjusted basis. Further, whenever the public accounts do not allow a proper compilation of accrual data, other items of revenue and expenditure in National Accounts, may in practice coincide with cash data.

to be generally agreed that the two approaches should be adopted in parallel, imposing on the member-states the obligation to provide detailed information at least on the transition from the cash to the ESA-95 general government balance.

The definition of the general government deficit adopted for the purpose of the fiscal surveillance framework is the balance of government revenue and expenditure excluding financial transactions. The reason for excluding from the deficit the operations related with financial assets lies in the fact that such transactions do not affect the net assets of the general government. Indeed, expenditures associated with the acquisition of financial assets are expected to generate positive returns and there is also the possibility of being reversed in the future. In this sense, for example, privatisation returns are not booked as revenues and do not have an impact on the deficit. Nevertheless, problems may arise when we consider loans and non-quoted shares in public enterprises, in particular when there is some evidence that such financial operations will never give rise to reimbursements and just aim at financing chronic losses. In this case, such capital injections should be entered above the line (i.e. as capital transfers). Thus, full information on government's yearly financial transactions with public enterprises should be made public in order to facilitate the assessment of the true fiscal position.

Government relations with public corporations are also at the centre of the debate on the definition of the boundary between government and non-government sectors. According to ESA-95, an institution is considered inside government if it is not able to finance more than 50 per cent of its costs with revenue from sales of goods and services. However, this criterion does not ensure by itself its economic viability and in many cases public enterprises accumulate losses and run into debt, frequently backed by implicit or explicit State guarantees. Therefore, for the effect of fiscal surveillance, all operations where government has direct responsibility should be considered.

The statistical issues previously mentioned are among the main reasons for the occurrence of significant deficit-debt adjustments. In general, deficit-debt adjustments are associated with three distinct situations. Firstly, the deficit is compiled on an accrual basis while public debt as taken into ac-

count in the excessive deficit procedure is a cash concept. Secondly, the government balance is a net concept, which means that financial operations cancel out, while the public debt relevant for the EU fiscal supervision is a gross concept. Thirdly, there are valuation effects associated with the calculation of public debt. Therefore, if member-states were required to provide more detailed information on the deficit-debt adjustments, this would allow the clarification of critical statistical issues, leading to increased transparency and credibility in the fiscal framework.

Overall, given the institutional constraints, the reduction of statistical problems requires the inclusion of more information in the excessive deficit procedure notifications. Specifically, member-states should provide more detailed information on the transition from cash to accrual accounting, on the financial relations with public corporations and on deficit-debt adjustments.

The issues related with the responsibilities attributable to the different national institutions that intervene in the compilation of fiscal data to be reported in the excessive deficit procedure notifications should also deserve some attention. These institutions are the national statistical authorities and the Ministries of Finance. In many member-states the compilation of fiscal data for the most recent years is the responsibility of the Ministry of Finance, which sometimes also formally reports the data. However, in order to increase transparency and to reduce data revisions, the authority responsible for the implementation of fiscal policy should be different from the authority responsible for the compilation and notification of fiscal data. Therefore, the national statistical authorities should actually be responsible for the compilation and reporting of all past fiscal data, leaving, at most, the current year's figures to be compiled by the Ministries of Finance.

5. CONCLUSION

Fiscal policy decisions are the responsibility of EU member-states. Nevertheless, the externalities of fiscal policy between the different member-states and their effects on monetary policy and long-term economic growth require active coordination and the avoidance of fiscal crises. Therefore, the EU needs to maintain a credible and ef-

fective fiscal framework. The experience of the fiscal framework established with the third stage of the EMU has been disappointing. Recent developments point to a deterioration of the fiscal position of several member-states, accompanied by the proliferation of temporary measures and the occurrence of sizeable statistical revisions. In addition, the Council's non-approval on 25 November 2003 of the Commission's recommendation, under article 104(9) of the Treaty, regarding the fiscal situation in Germany and France, severely reduced the credibility of the fiscal surveillance framework. Nevertheless, fiscal developments and their compliance with the reference values for the general government deficit and for debt-ratio have become a matter of public domain, reducing the discretionary power of governments. The origin of some of the current difficulties could be traced back to the budgetary surveillance framework set down in the Treaty and in the SGP. In fact, the non-automatism of sanctions lead to unsolved intertemporal inconsistency problems. At present, the practical impossibility of finding consensus that would allow a revision of the Treaty and the SGP, impede substantial changes to the fiscal surveillance framework and make it impossible to implement first-best reforms. Conversely, it is undesirable to base a reform on a set of proposals acceptable to all countries, which would mean a loosening of the fiscal framework, in particular through the removal of specific expenditure items from the relevant definition of deficit or by considering that structural reforms justify higher deficits in the short term.

In the context of the current debate and taking into consideration the existing institutional constraints, it is necessary to reinforce the Commission's ability to contribute to effective peer pressure, through clear and sound assessments of fiscal developments in member-states. Such assessments should also increase the scrutiny of public opinion and financial markets, giving to governments further incentives to maintain public finances on a sustainable path. A stronger role for the Commission requires a clearer definition of what is considered the medium-term fiscal objective for each member-state, which should depend on its specific circumstances, such as the sensitivity of the fiscal balance to the output gap, the growth rate of potential output, the public debt ra-

tio, the amount of contingent or implicit liabilities related to government guarantees or the future payment of pensions. In addition, the budgetary process should change its timings in order to allow the assessments made public at the EU level to precede the approval of the national budgets. Finally, the quality, timeliness and reliability of public finance data should be improved through the disclosure of more detailed information on the consistency of cash and accrual deficits, the deficit-debt adjustments, the relations with public corporations and the contingent and implicit liabilities of general government. In addition, it is necessary to separate the responsibility for the implementation of fiscal policy from the responsibility to compile and report public finance statistics. Moreover, an enhanced role for the national statistical authorities and the Eurostat would be desirable, via an increase of their technical ability and independence, accompanied by greater accountability. These reforms could have a strong positive effect on member-states' fiscal medium-term positions and do not require significant changes to the Treaty or the SGP.

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