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Marco Buti and André Sapir

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Marco Buti, European Commission
André Sapir, Université Libre de Bruxelles, Bruegel and CEPR

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Centre for Economic Policy Research
90–98 Goswell Rd, London EC1V 7RR, UK
Tel: (44 20) 7878 2900, Fax: (44 20) 7878 2999
Email: cepr@cepr.org, Website: www.cepr.org

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ABSTRACT

Fiscal Policy in Europe: The Past and Future of EMU Rules from the Perspective of Musgrave and Buchanan*

During the ‘Golden Age’ that lasted until the mid-1970s, Europe witnessed a "public finance" phase, when the three sides of Musgrave’s triangle - allocative efficiency, redistribution and cyclical stabilisation - seemed to reinforce one another. EMU's fiscal rules - embodied in the Maastricht Treaty and the Stability and Growth Pact - can be regarded as the attempt by European governments to overcome the subsequent "public choice" phase à la Buchanan which was characterised by increasing budget deficits and trade offs between allocative efficiency and redistribution. The original Stability Pact delivered only partly. A rigorous enforcement of the reformed Pact will depend on two conditions: the renewed ownership of the rules by key players and the relative weight of the perceived negative externalities of fiscal misbehaviour versus the political costs of attempting to limit the partner countries’ room for manoeuvre.

JEL Classification: E6, H3 and H6
Keywords: fiscal policy, EMU and Stability Pact

Marco Buti
Deputy Director-General DG ECFIN
BU-1 01/212
European Commission
Avenue de Beaulieu 1
B-1049 Brussels
BELGIUM
Email: marco.buti@ec.europa.eu

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André Sapir
ECARES
Université Libre de Bruxelles
CP 114
50 Avenue Roosevelt
1050 Brussels
BELGIUM
Email: asapir@ulb.ac.be

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Submitted 20 August 2006

1. Introduction

Views regarding the role of government and public spending have greatly evolved over time, both influencing and reflecting the evolution of actual public intervention. During the last 40 years, the intellectual debate has been entirely dominated by the views of Richard Musgrave and James Buchanan, who together published a little while ago a fascinating account of their respecting conceptions in *Public Finance and Public Choice: Two Contrasting Views of the State* (Buchanan and Musgrave, 1999). The public finance view of the state is essentially that the state can and must correct the excesses of the market. By contrast the public choice view holds that interventions by the state create problems of their own because the state acts not in the general public interest, as postulated by the public finance view, but in the interest of certain groups.

Nowhere has the role of government and public policy been more important than in Europe. The paper begins with an overview of European fiscal policy since World War Two. It distinguishes between two phases: a public finance phase, associated with Europe's 'Golden Age', and a public choice phase, during which Europe's public spending became unsustainable. Section 3 examines how the fiscal rules of Europe's Economic and Monetary Union (EMU), and in particular the Stability and Growth Pact (SGP), were meant to remedy this situation and why they partly failed to deliver. Section 4 looks at the reform of the SGP enacted in 2005 and section 5 provides a discussion of whether the reform will be successful in delivering sustainable public finances. Section 6 concludes.

2. Sixty years of public finance in Europe: a bird's eye view

2.1 The 'Golden Age' (1945-1973)

For 30 years, between the mid-1940s and the mid-1970s, Europe witnessed a 'Golden Age' of growth, stability and social cohesion. The post-war reconstruction created an economic and social environment, which ensured that the three sides of this 'magic triangle' operated in a mutually-reinforcing manner. The post-war 'welfare state' reflected a wide political consensus, which was broadly shared across Western Europe. Business was guaranteed a stable economic, industrial and social environment for sustained growth that reflected an implicit social contract with the people that the creation of new wealth would be fairly distributed. This commitment was enshrined in new features of the post-war consensus: a universal standard of social protection together with equal opportunity of education and in employment regardless of birth.[1]

While economic stability and social cohesion were no doubt crucial conditions for European growth during those years, rapid economic growth was equally crucial to ensure the sustainability of economic stability and the social protection system.

The economic and social conditions in Western Europe during the years 1950-1973 were truly remarkable. The region enjoyed average annual growth rates of well over 4 percent for GDP and nearly 4 percent for GDP *per capita.* As a result, Europe's standard of living witnessed a rapid catching-up with the United States: compared to a benchmark of 100 for the US, GDP *per capita* (measured at purchasing power parity) in Western Europe rose from around 40 in 1950 to around 70 in 1973. At the same time, inflation stood on average at 4 percent and unemployment at 2 percent.

Throughout this period, the size of the welfare state increased considerably in Europe. By 1970 the share of total government expenditure in GDP reached between 35 and 40 percent in most countries – not considerably higher than in the United States, where total government expenditure stood at 32 percent of GDP.

The creation and expansion of the welfare state was then viewed as a powerful tool in the hands of benevolent governments seeking to maximise social welfare. Most economists embraced the vision expounded by Richard Musgrave in his treatise *The Theory of Public Finance* published in 1959. Musgrave defined three major economic roles for government: the provision of public goods and other measures to correct for market failures and improve the allocation of resources; the redistribution of income to achieve equitable distribution of income among households; and the stabilisation of economic activity to attain high levels of employment with reasonable stability of prices.

Higher taxes and social expenditures were seen as means not only to improve the distribution of income, but also to improve the allocation of resources and growth (by correcting market failures in the labour market) and to promote the stabilisation of output (via the automatic stabilisers provided by taxes and social expenditures). Moreover, the high growth rates helped to keep public debt under control thereby ensuring the

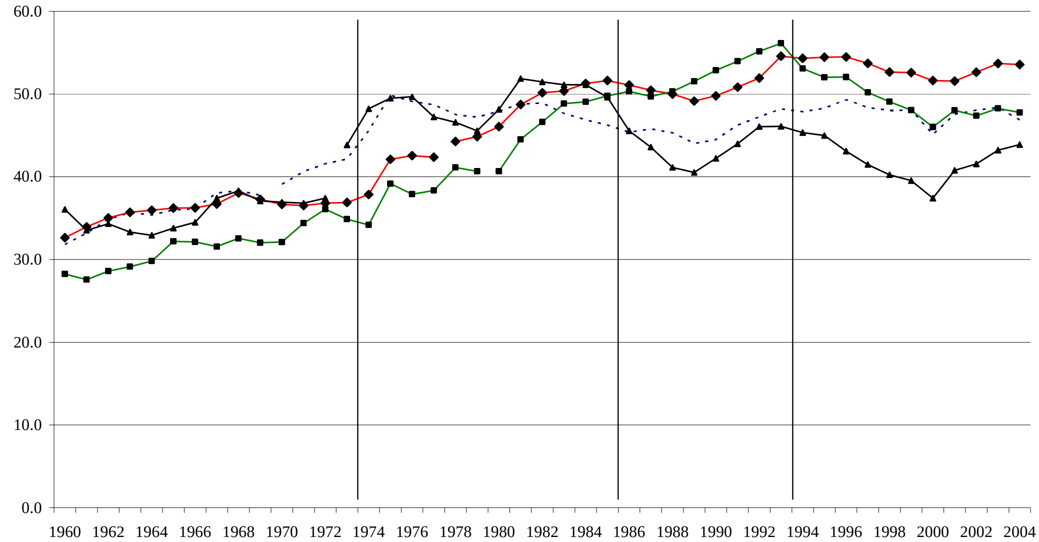
[1] See Sapir et al. (2004).

sustainability of public finances. And indeed, during the ‘Golden Age’, the three sides of the Musgravian triangle seemed to reinforce one another. There appeared to be no trade-off between allocative efficiency, redistribution and stabilisation.

The apparent absence of such trade-off during this period is well illustrated by the situation of France, Germany, Italy and the United Kingdom, the four largest European countries, where the share of total public expenditure (and revenue) in GDP reached 35-45 percent in 1973 (see figures 1 and 2), with about 15 percent devoted to social expenditure (figure 3).

Despite the rapid growth of public expenditure in these countries prior to 1973, their public debt basically remained under control during the period 1960-1973 (figure 4). In the United Kingdom, where the debt-to-GDP ratio was well over 100 percent in 1960, it actually declined by nearly 60 percentage points. It also declined sharply in France, reaching less than 20 percent in 1973. In Germany it remained constant around 20 percent throughout the period. Only in Italy did the debt-to-GDP ratio grow, reaching around 50 percent in 1973.

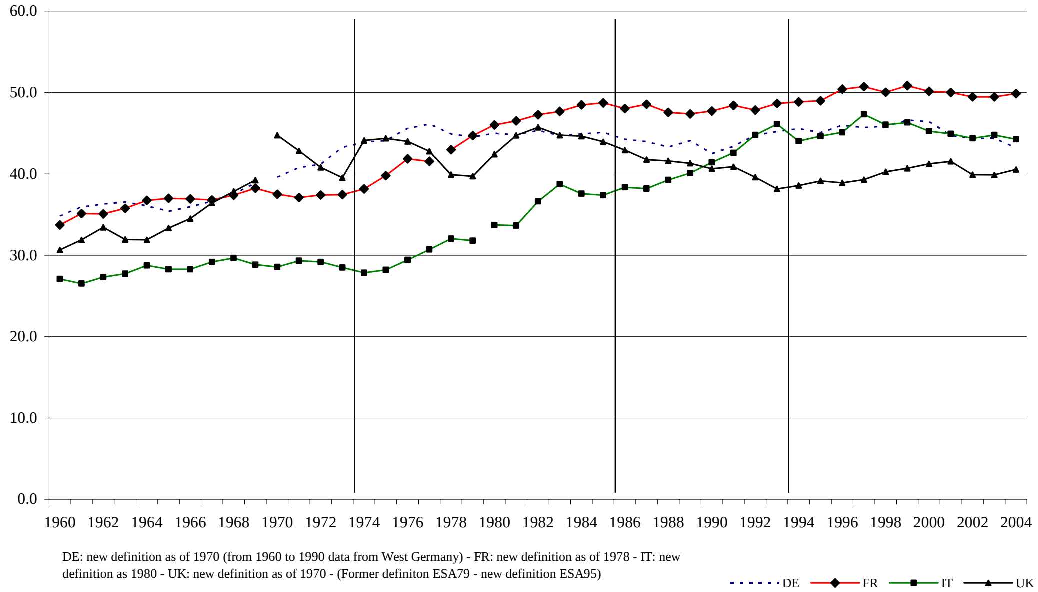
Figure 1 – Total public expenditure 1960-2004



DE: new definition as of 1970 (from 1960 to 1990 data of West Germany) - FR: new definition as of 1978 - IT: new definition as of 1980 - UK: new definition as of 1973 - (former definiton EAS79 - new definition ESA95)

Source: European Commission

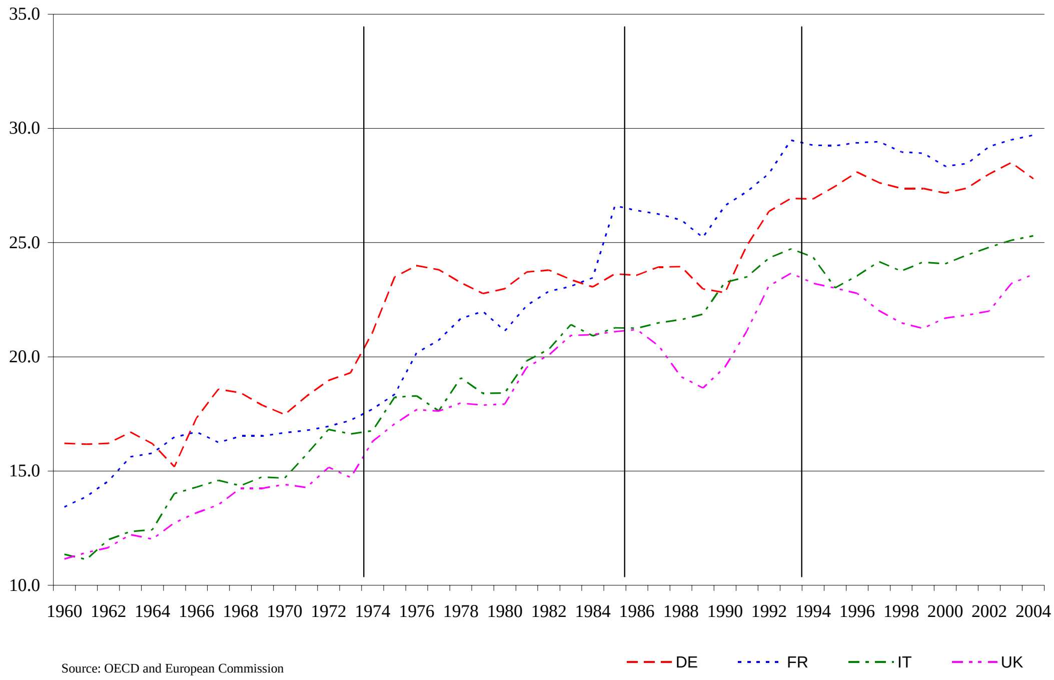
Figure 2 – Total Public Revenue 1960-2004



DE: new definition as of 1970 (from 1960 to 1990 data from West Germany) - FR: new definition as of 1978 - IT: new definition as 1980 - UK: new definition as of 1970 - (Former definiton ESA79 - new definition ESA95)

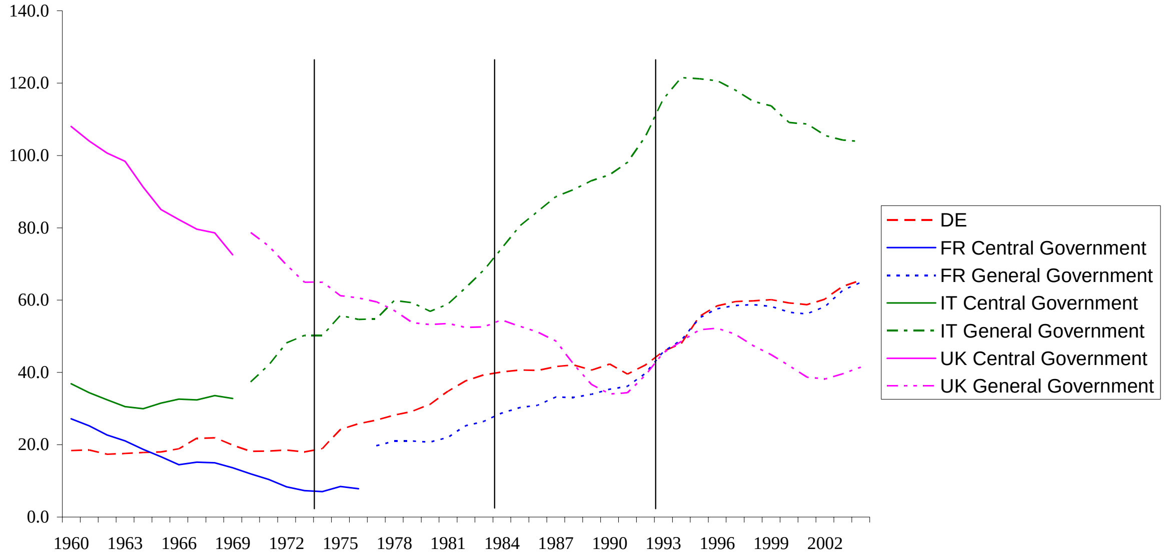
Source: European Commission

Figure 3 – Public Social Expenditure 1960-2004



Source: OECD and European Commission

Figure 4 – Gross Public Debt 1960-2004



Source: European Commission

Table 1 shows, however, that the favourable development with respect to debt sustainability during the period 1961-1973 was due mainly to a 'snow-ball' effect rather than to underlying public finance decisions. In all four countries, the combination of high GDP growth rates and low real interest rates produced negative 'snow-ball' effects that led to substantial declines in public debts. Apart from the United Kingdom, however, all countries ran primary budget deficits that tended to work in the opposite direction. In Italy the latter actually swamped the negative 'snow-ball' effect, resulting in an accumulation of debt.

Table 2 shows that public finance also tended to play a stabilisation role during the period 1961-1973. Public debt decreased in 'good times' and increased in 'bad times' in Germany and Italy. In France and the United Kingdom, two countries where the debt-to-GDP ratio decreased substantially during the period, the public debt actually decreased during both good and bad times.

Even in the heydays of the 1960s, however, not everyone shared Musgrave's activist and benign vision of the public sector in the economy. In *The Calculus of Consent* published in 1962 James Buchanan and Gordon Tullock presented a radically different view of the public sector. They argued that, in majoritarian political systems, special interest groups and coalitions tend to generate an over-expansion of the public sector, with increasing transfers in their favour and rising taxes, which lead deleterious economic and social consequences[2]. To prevent such outcome Buchanan and Tullock advised governments to adopt rules that would constrain the expansion of the public sector.

Table 1 – Breakdown of Debt Accumulation 1961-2004

Table.1 Breakdown debt accumulation

in % of GDP	1961-2004			1961-1973			1974-1983			1984-1992			1993-2004		
	Δ debt ratio	Snow-ball effect	Primary balance + SFA	Δ debt ratio	Snow-ball effect	Primary balance + SFA	Δ debt ratio	Snow-ball effect	Primary balance + SFA	Δ debt ratio	Snow-ball effect	Primary balance + SFA	Δ debt ratio	Snow-ball effect	Primary balance + SFA
Germany	47	21	26	0	-9	8	21	5	17	3	1	2	23	24	-1
France	26	-8	33	-20	-23	3	7	-11	18	13	8	5	25	18	7
Italy	63	-25	88	10	-31	41	18	-48	66	37	15	22	-1	38	-40
United Kingdom	-81	-62	-19	-58	-44	-14	-12	-31	18	-13	6	-20	2	6	-4

Source: Ecfin calculations on AMECO data and national sources. Calculations for 1961-1970 for Italy and UK and for 1961-1977 for France are based on central government debt figures from the Bordo-Jonung database.

Table 2 – Debt Accumulation in Good and Bad Times 1961-2004

Table.2 Debt accumulation in good times (GT) and bad times (BT)

in % of GDP	1961-2004			1961-1973			1974-1983			1984-1992			1993-2004		
	Δ debt ratio	Δ GT	Δ BT	Δ debt ratio	Δ GT	Δ BT	Δ debt ratio	Δ GT	Δ BT	Δ debt ratio	Δ GT	Δ BT	Δ debt ratio	Δ GT	Δ BT
Germany	47	3	44	0	-4	4	21	5	16	3	-1	4	23	3	20
France	26	5	21	-20	-13	-7	7	4	3	13	3	10	25	11	15
Italy	63	15	48	10	-2	12	18	-4	22	37	25	12	-1	-4	2
United Kingdom	-81	-35	-46	-58	-20	-37	-12	-8	-4	-13	-10	-3	2	4	-2

Source: Ecfin calculations on AMECO data and national sources. Calculations for 1961-1970 for Italy and UK and for 1961-1977 for France are based on central government debt figures from the Bordo-Jonung database.

2.2 The Next Thirty Years (1973-2005)

During the next 30 years the economic conditions in Europe have been less rosy. Potential growth fell by nearly one full percentage point, reaching now only 2 percent a year, compared with almost 3.5 percent in the United States, where growth has actually increased. And while it is true that GDP *per capita* increased at the same rate in Europe as in the United States throughout the period, this actually implies that the income gap between the United States and Europe has remained constant. Hence the rapid catching up process of the Golden Age actually stopped altogether 30 years ago. At the same time, inflation first rose sharply during the 1970s and then fell steadily during the 1980s and 1990s, staying around 2 percent since *circa* 2000. By contrast, unemployment, which also

[2] See also Buchanan (1967). Since then a burgeoning literature of 'political economics' has explored the interplay between political and institutional systems and public finances. For a thorough overview, see Persson and Tabellini (2000).

rose rapidly during the 1970s and the early 1980s, never much declined thereafter, hovering instead between 8 and 10 percent.

The ‘magic triangle’ started to unravel in the 1970s with the two oil shocks. Since then the pressure has further mounted as a result of three profound and interconnected changes in the socio-economic environment taking place across Europe and the world: demographic patterns, technological breakthroughs and globalisation.

Whereas rapid growth, macroeconomic stability and the welfare state had been mutually supportive during the ‘Golden Age’, the mixture of slow growth, macroeconomic instability and a welfare system conceived in a different set of circumstances proved difficult to manage in the years after 1973.

In fact three sub-periods must be distinguished.

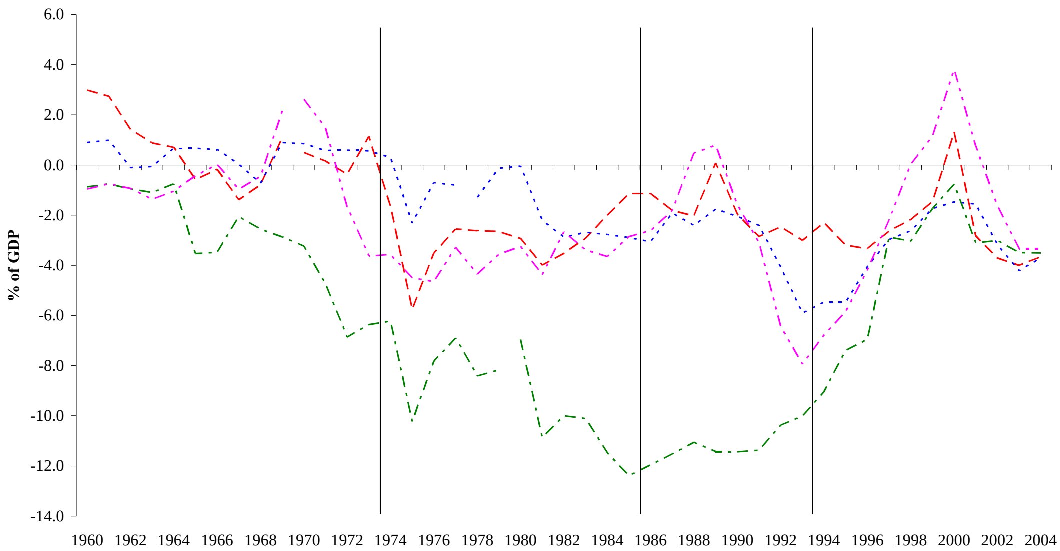
From the mid-1970s to the mid-1980s

During the period 1974-1985, the combination of slow growth and high unemployment resulted in increased demands for social protection that led to severe consequences for public finances. The share of total government expenditure in GDP grew rapidly after 1973, reaching 45-50 percent in many European countries in 1985 – an increase of more than 10 percentage points compared to 1970. This spectacular increase mainly involved two items: government consumption and social transfers. It was financed partly by additional public revenue and partly by public borrowing (see figure 5).

By the mid-1980s, Europe was stuck in a negative spiral: lower GDP growth and employment rates meant increasing public expenditure, which required increasing public revenue, which in turn implied higher social contributions and higher direct taxes, thereby reducing the incentive to work and to invest, hence further reducing the prospects for output and employment growth.

The reason why Europe seemed durably trapped in this spiral was twofold. First, the shocks to the system were long-lasting. The slowdown of growth was initially not perceived as permanent which led policy makers to bet on stabilisation rather than adjustment. After the two oil shocks of 1973 and 1979, Europe was confronted with population ageing, the information technology revolution and globalisation, all of which substantially increased the demand for social protection. Second, the system seemed politically unable to reform itself and to establish a new social contract aimed at increasing growth and preserving social welfare. The problem was to find a way out of the following dilemma: preserving the costly European social model required higher GDP growth, but increasing growth also required adapting the social model to the new socio-economic environment.

Figure 5 – Budget Balance 1960-2004



DE: new definition as of 1970 (from 1960 to 1990 data of West Germany) - FR: new definition as of 1978 - IT: new definition as of 1980 - UK: new definition as of 1970 (former definition ESA79 - new definition ESA95)

Source: European Commission

The over-expansion of social expenditures (see figure 3) led to debt accumulation not only in Italy, but now also in France and in Germany (see figure 4). As shown in table 1, all four large European countries (including the United Kingdom) ran large primary budget deficits during this period, which added substantially to the debt. This was, however, partially compensated by negative ‘snow ball’ effects (except in Germany), which persisted during this period as the slow down in GDP growth was accompanied by a reduction in real interest rates due to increased inflation.

Table 2 shows that public finance ceased to play a stabilisation role during the period 1974-1983. Public debt now increased during both good and bad times in France, Germany and Italy. By contrast, in the United Kingdom, public debt continued to decrease during both good and bad times.

In other words compared to the ‘Golden Age’, when the three sides of the Musgravian triangle seemed to reinforce one another, the decade following 1973 witnessed the emergence of trade-offs between allocative efficiency and redistribution in the manner envisaged by Buchanan and Tullock.

From the mid-1980s to the mid-1990s

During the period 1984-1992, sustained slow growth and high unemployment resulted in a sustained deterioration of public finances.

The over-expansion of social expenditures continued unabated (see figure 3). By 1992, public social expenditure had reached 29 percent of GDP in France (compared to 16% in 1970), 27 in Germany (against 17% in 1970), 24 in Italy (15% in 1970) and 23 percent in the United Kingdom (against 14% in 1970). This led to further debt accumulation in France, Germany and Italy (see figure 4). As shown in table 1, all these three countries still ran primary budget deficits during this period, although much less than during the previous decade. But now the ‘snow ball’ effect had finally turned positive in all the four large European countries as real interest rates (which had increased due to disinflationary policy) became larger that GDP growth rates, thereby adding to debt accumulation.

Table 2 indicates that public finance failed to regain a stabilisation role during the period 1984-1992. Public debt continued to increase during both good and bad times in France and Italy (but less so in Germany). In the United Kingdom, however, public debt continued to decrease during both good and bad times. By 1992, the level of public debt had reached around 40 percent in France (20 points higher than in 1974), Germany (24 points higher than in 1974) and the United Kingdom (25 points lower than in 1974), and more than 100 percent in Italy (57 points higher than in 1974).

Therefore the trade-offs between allocative efficiency and redistribution that had emerged during the previous decade continued to operate during the current decade.

From the mid-1990s to the mid-2000s

In 1993, total government expenditure in the EU reached its highest-ever peak at 51 percent of GDP, with 56 percent in Italy (an increase of 25 percentage points since 1970), 55 percent in France (plus 18 points since 1970), 49 percent in Germany (plus 10 points) and 46 percent in the United Kingdom (plus 2 points only) – it also reached a record high in the United States, but at a level of only 37 percent. With public revenue at 45 percent of GDP, this meant that 1993 was also the year when public borrowing reached its highest-ever peak in Europe with 6 percent of GDP on average and 10 percent in Italy, 7 in the United Kingdom, 6 in France and 3 in Germany.

The Maastricht fiscal consolidation process, launched in 1993, was to put an end to the deterioration of public finances in most EU countries that had started 20 years earlier. By 1999, when the euro was introduced, public borrowing was down to less than 1 percent. The turnaround was achieved by a combination of reduced government expenditure and increased government revenue. In 1999, total government expenditure in the EU had come down to 47 percent of GDP (53% in France, 48 in Germany and Italy, and 39% in the United Kingdom) – four points below the peak of 1993, but still about 10 points above the 1970 level. At the same time, total government revenue had reached 46 percent of GDP (56% in Italy, 55 in France, 49 in Germany and 46% in the United Kingdom), its highest-ever level and again about 10 points above the 1970 level.

By the year 2000, it seemed that fiscal consolidation in the EU had been achieved. For the first time since 1970, the consolidated budget of the EU countries posted a positive balance[3]. Government expenditure also seemed to be under control. In reality, however, the spiral of low growth and high public expenditure was still fairly intact. The year 2000 had been an exceptional year, with a growth rate of GDP in the EU at 3.5 percent, one full point above the trend for the period 1986-2000. When the downturn hit in 2001, public expenditure and public borrowing went back on the rise. Since 2003, total government expenditure has been above 47 percent of GDP on average in the EU and public borrowing more than 2 percent of GDP, and well above the 3 percent mark in France, Germany and Italy (but also, although to a lesser extent, in the United Kingdom).

Despite efforts at consolidation during this period, the debt-to-GDP ratio actually increased substantially in France and Germany (see figure 4). As shown in table 1, the main culprit was the large ‘snow ball’ effect due to the large and positive gap between real interest rates and GDP growth rates. This effect was even larger in Italy, but there it was more than compensated by fiscal retrenchment that to primary budget and a small decrease in the debt ratio.

Table 2 indicates that during this period public finance regained a stabilisation role in Italy but surprisingly lost it in the United Kingdom, where public debt actually increased in good times and decreased in bad times. In France and Germany public debt continued to increase

[3] This however included one off revenue of some 1% of GDP arising from the sale of UMTS licences.

during both good and bad times. By 2004, the level of public debt had reached well over 60 percent in these two countries (more than 40 points higher than in 1974). By contrast it remained around 40 percent in the United Kingdom (25 points lower than in 1974) and around 100 percent in Italy (about 60 points higher than in 1974).

During the two decades spanning from the mid-1970s to the mid-1990s, therefore, government expenditure increased sharply in the large European countries, except the United Kingdom. It fell slightly thereafter, although it remained at a very high level compared to the early 1970s. Moreover the composition of public expenditure changed dramatically during the period, with the social expenditure accounting since the 1990s for about 60 percent of total expenditure compared to barely 40 percent in 1970.

The combination of high levels of public expenditure and a high share of it devoted to social spending is the main feature of European public finance for the past 30 years. It contrasts sharply with the situation that prevailed during the 30 years after World War Two, when public expenditure was much lower and the share of it devoted to social spending was also lower. The shift from one situation to the other meant that the benign use of public finance associated with the view of Musgrave gave way to a deleterious approach more akin to the vision of Buchanan and Tullock.

3. Enters Europe: the run up and the early years of EMU

3.1 Maastricht and the Stability Pact: what was expected…

After the rise in public spending of the previous years, several EU countries entered the 1990s with public finances out of control. As discussed above, the period of strong growth of the second half of the 1980s was not used to reduce deficits and debt: the structural primary balance was merely stabilized at around balance and public debt continued to grow albeit at a lower pace.

As Buchanan and Tullock (1962), and the ensuing political economy of public finance literature, argued the only way to counter the deficit bias of governments is to adopt fiscal rules. Whilst several European countries already had public finance rules and guidelines in the early 1990s, they were often ineffective. Hence, the choice was made to set up rules at the EU level. The Maastricht criteria codified the imperative of consolidation as a condition for joining the euro area. As a complement to the Treaty rules, the Stability and

Growth Pact (SGP) aimed at making budgetary discipline a permanent feature of EMU. As such, the Pact is commonly interpreted as a major building block of EMU's architecture: the SGP “must rank as one of the most remarkable pieces of policy coordination in world history. Its construction makes it in some respects comparable to the founding of the Bretton Woods system.” (Artis, 2002: 155).

The SGP consists of a preventive arm which aims to strengthen the surveillance of budgetary positions and the surveillance and co-ordination of economic policies, and a dissuasive arm which aims to accelerate and clarify the excessive deficit procedure (EDP) of the Treaty.

The approach chosen by the framers of the SGP is two-pronged. First, the 3 per cent of GDP reference value for triggering the excessive deficit procedure, should be treated as much as possible a 'hard ceiling', the breaking of which would put in motion "a quasi-automatic mechanism" (Stark, 2001) for imposing sanctions, with escape clauses defined as narrowly as possible and legally binding deadlines imposed for taking decisions. This feature strengthened the role of the 3% deficit threshold which had been introduced relatively late in the negotiations for the Maastricht Treaty and then surrounded with judgemental qualifications.

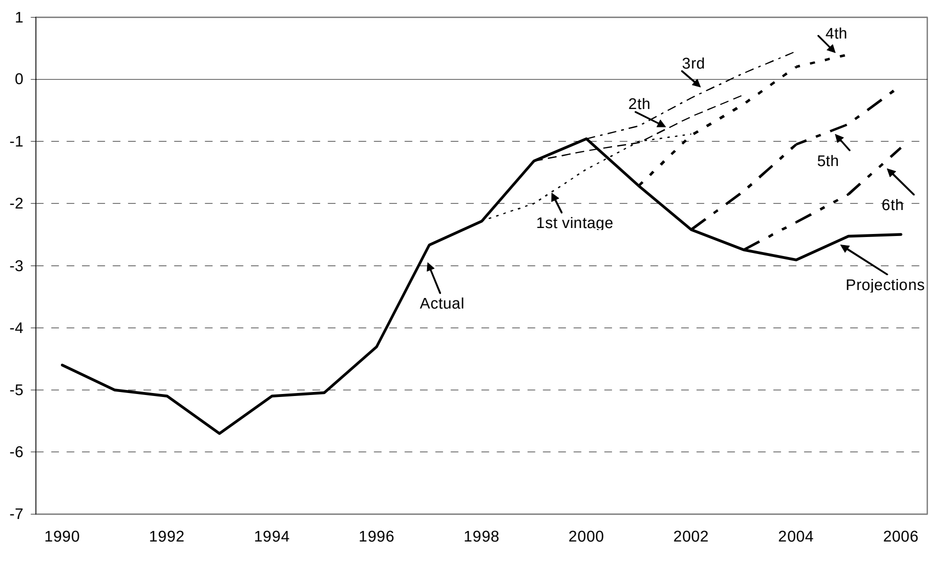
Second, Member States should commit themselves to a "medium-term budgetary objective of close-to-balance or in surplus", thereby providing on average a safety margin of the order of 3 percentage points of GDP against breaching the 3 per cent deficit ceiling, enough to ensure that movements in the budgetary balance in response to cyclical fluctuations would leave the deficit under 3 per cent of GDP in all cases but few rare recession episodes. This was to be the function of the so-called preventive arm of the SGP, which fleshes out the surveillance economic policies provisions of the Treaty, in particular by institutionalising the annual submission by Member States and examination by the Council of stability programmes setting out their medium-term budgetary strategy to achieve and maintain the close-to-balance or in surplus objective, including the accompanying economic assumptions, and putting in place an early-warning mechanism for addressing recommendation in case of "significant divergence of the budgetary position from the medium-term objective, or the adjustment path towards it."

Given the political priority to put the deficit under control, improving cyclical stabilisation and allocation efficiency were seen as secondary objectives. However, apart from a transitory effect, restoring basic conditions of fiscal discipline was considered as a pre-condition to pursue these other objectives. First of all, the cut in public spending brought about by the budgetary consolidation, by reducing the role of the state in the economy and opening up the way to lower average and marginal tax rates, was seen as efficiency-enhancing. Second, restoring fiscal prudence in normal times was also considered as a pre-condition for using fiscal policy for stabilization purposes: close-to-balance positions would allow automatic stabilisers to play fully without endangering the 3% ceiling.

3.2 … And what actually happened

Undeniably, the imposition of the Maastricht budgetary targets at the beginning of the 1990s set off a genuine consolidation process. In most countries budget deficits declined substantially after 1993, the year which marked the entry into force of the Maastricht Treaty and in which the euro area registered the historically high deficit ratio of 5.5% of GDP. Aided also by lower interest rates thanks to reduced risk premia, the cyclically-adjusted balance improved by 4.5 percentage points in the euro area between 1993 and 1999 (Figure 6), and was brought back below the 3% of GDP threshold in all Member States by 1997, except Greece.

Figure 6 – Cyclically adjusted balance of the Euro Area

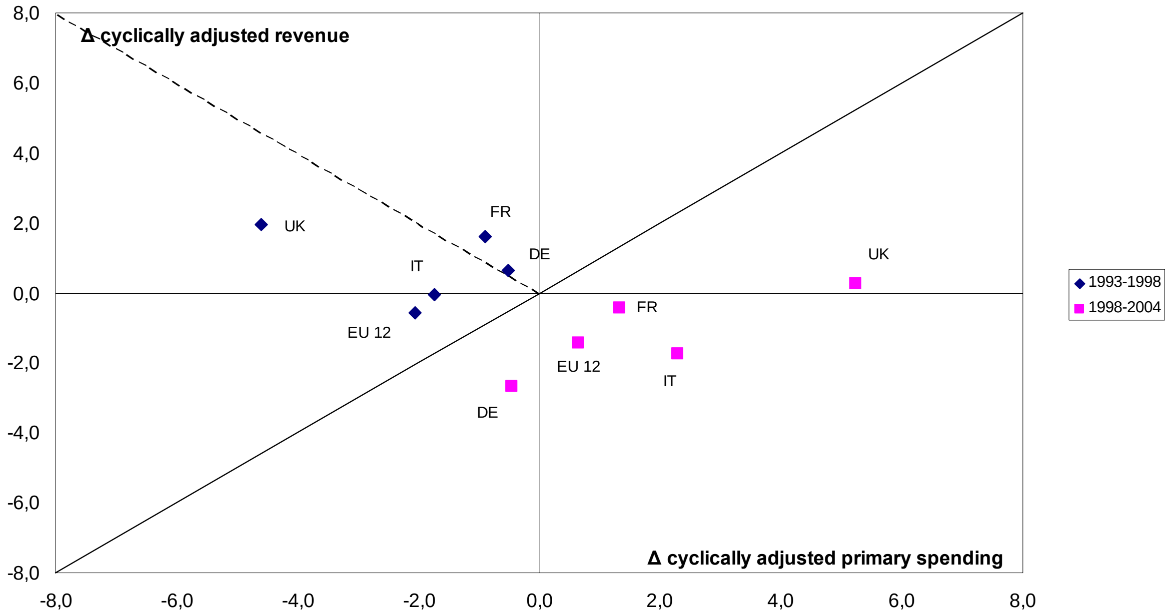


Source: European Commission

Amongst the large euro area countries, Italy managed to reduce their budget deficits by 7 percentage points of GDP between 1993 and 2000, although the reduction in the interest burden explains a sizeable share of the retrenchment. In contrast, Germany and France, traditional bastions of fiscal prudence, struggled to reduce budget deficits and keep control of public debt fuelled, respectively, by the costs of unification and subdued economic performance in the first part of the period. In these countries public debt actually increased though starting from a level below the 60% of GDP reference value.

The composition of the fiscal consolidation is shown in Figure 7 which breaks down the discretionary fiscal policy changes into changes in total revenue and in primary expenditure. The diagonal from top right to bottom left indicates the direction of the budgetary adjustment: the area above it marks an improvement in the cyclically-adjusted primary balance, while the area below it indicates a structural deterioration. The diagonal from top left to bottom right marks the composition of the adjustment between expenditure changes and revenue changes.

Figure 7 – Composition of the adjustment: 1993-1998 vs 1998-2004



Source: European Commission

In the run up to EMU, the four countries and the euro area as a whole lie above the top right - bottom left diagonal meaning that their cyclically-adjusted primary balance improved during the period. Moreover, though the various degrees, primary spending was reduced in all countries.

While the retrenchment in the run up to EMU is commonly considered a success, the SGP, which was supposed to consolidate Maastricht's achievements, has fallen short of the expectations of its framers. At close to 3 per cent of GDP the cyclically-adjusted deficit of the euro area remains as distant from the close-to-balance as ever since the launch of EMU.

As shown in Figure 6 above, the cyclically-adjusted balance for the euro area as a whole has progressively deteriorated in the years since 2000, falling well short of the commitments enshrined in the early updates of the national Stability programmes. The turnaround in both direction and composition of discretionary fiscal policy is confirmed by Figure 7 which shows that that the structural primary balances deteriorated since the end of the 1990s: while the tax revenue was reduced, primary expenditure started to climb again.

This analysis shows that the *de facto* suspension of the excessive deficit procedure in the cases of Germany and France after November 2003 (see below), potentially signalling the amputation of the dissuasive arm of the Pact, had been preceded by a progressive loss of credibility of the preventive arm, as evidenced by persistent negative gaps between fiscal projections and outcomes of successive round of stability programmes. However, the three largest countries in the euro area (France, Germany and Italy) appear largely to blame for the credibility gap affecting stability programmes, as their fiscal projections suffer a significant bias to under-predict actual deficits[4].

In sum, following the halting in connection with the Maastricht process of the unprecedented non-war debt increase of the previous two decades, the SGP has apparently failed to eradicate the underlying - and ultimately unsustainable - deficit bias of fiscal policies. In particular, this bias manifests itself through the continuation of the tendency to run expansionary policies or to fail to consolidate in good times, as shown by the deterioration of cyclically-adjusted balances in the last upswing. More importantly, EMU's fiscal rules do not seem to have brought about a shift towards more friendly growth policies, also in the public finance area.

[4] As shown in Buti and van den Noord (2004a), producing over-optimistic forecast is particularly tempting in electoral periods as a way to increase the room for manoeuvre of discretionary fiscal policy.

4. More intelligent, but more complex: the new Pact

4.1 The reform of the SGP

The failure of the SGP ‘mark I’ is epitomised by the repeated breaches of the 3 per cent of GDP deficit ceiling by individual Member States. Since 2002 six out of the twelve euro area members have been subject to the excessive deficit procedure; the early-warning mechanism has been invoked in four cases. Even more damaging to the credibility of the Pact has been the perceived disavowal of the original framework, specifically, its enforcement mechanism, by key Member States. Already detectable in the apparent unwillingness of the Council to let the early-warning mechanism run its normal course in the cases of Germany and Portugal in February 2002, the crisis became explicit the following year. In November 2003 the excessive deficit procedures against France and Germany were *de facto* suspended following the Council’s failure to endorse Commission recommendations that the procedures be stepped up in accordance with the Pact's result-based approach to compliance.

While the debate in academic circles showed the depth of the division among economists, a certain consensus gradually emerged in the course of 2004 among the main policy players as to what changes were needed to the EMU fiscal framework. It was recognised that EMU needed numerical fiscal rules (since financial market discipline and national procedures were not deemed sufficient to ensure budgetary discipline) and that any radical changes to the rules introduced in 1992 (Maastricht Treaty) and 1997 (SGP) would be highly problematic. “Internal adjustment” – as dubbed by Buti et al. (2003) - of the existing framework rather than a radical overhaul of the rules came to be regarded as the only feasible way ahead. It was also acknowledged that complementary measures at the national level (such as better budgetary procedures and independent fiscal councils) would be highly desirable. There was agreement that internal reforms should include action to improve fiscal policy in good times, more consideration of public debt and long-term sustainability in assessing Member States’ budgetary positions, a greater focus on cyclical developments and more transparency in fiscal data. Other aspects were more controversial: these included changes to the excessive deficit procedure and a stronger role for the Commission as enforcing agency.

The risks involved in embarking on a reform process under the pressure of unfavourable fiscal developments were also highlighted in the debate: the credibility of the framework itself could be endangered and the reform process could prove very long and uncertain. It was also noted that if the problem was primarily one of adherence to the rules, the priority should be to ensure rigorous implementation of the existing rules rather than to change them. At the same time, it was widely recognised that simply attempting to apply the existing rules after the watershed of November 2003 was not a viable option. Re-establishing a sense of ownership of the fiscal rules by all parties would be the precondition for their effective enforcement.

At the request of the European Council, in September 2004 the Commission issued a Communication suggesting a number of more changes to the Pact which, while preserving its overall architecture, aimed at avoiding pro-cyclical policies, especially in good times; better defined the medium-term objective by taking into account country-specific circumstances and reforms; gave greater prominence to the debt criterion; modify the implementation of the excessive deficit procedure, in particular by allowing more time to correct an excessive deficit under certain circumstances; and improved governance and enforcement (European Commission, 2004).

After a difficult and at times heated debate, an agreement was reached at the ECOFIN Council of March 2005. The guidelines of the reform were set out in a report which envisaged changes to both the preventive and corrective arms of the Pact (Council, 2005).

On the preventive side (i.e. the medium-term targets and the adjustment path towards them), medium-term budgetary objectives (MTO) were now to be somewhat differentiated from one country to another on the basis of debt ratios and potential growth rates. Targets should be specified in structural terms, i.e. cyclically-adjusted and net of the effects of temporary measures, and should range between a deficit of 1% of GDP and a small surplus. The latter would apply to high-debt, slow-growth countries. Implicit liabilities should also be taken into account, once the Council agrees on criteria and methodological aspects. Major structural reforms with long-term fiscal benefits should be taken into consideration both when defining the adjustment path towards the medium-term objective and when considering temporary deviations from the target.

On the corrective side (i.e. the application of the excessive deficit procedure), a modification was introduced in the definition of the "exceptional cyclical circumstances" which may justify that the reference value for the deficit is exceeded: a breach of the threshold should now be considered exceptional if it results from a negative growth rate or an accumulated loss of output during a protracted period of very low growth relative to potential growth. When evaluating deficits exceeding the 3% limit, the Commission should take into account a number of factors ranging from cyclical conditions to the implementation of the Lisbon agenda and policies to foster R&D and innovation, from debt sustainability to the overall quality of public finances, from financial contributions to international solidarity to fiscal burdens related to European unification. However, any excess over the 3% deficit threshold should remain limited and temporary. The implementation of pension reforms establishing a compulsory funded pillar should also be taken into consideration, especially when assessing whether an excessive deficit has been corrected.

While confirming that, as a rule, the deadline for the correction of an excessive deficit remains the year after it is identified, the Council decided that the initial deadline could be set one year later if there were special circumstances, and could be revised at a later stage if unexpected adverse economic events with major unfavourable budgetary effects occurred.

The Council called for giving a stronger weight to public debt, but was not able to agree on quantifying the minimum debt reduction for countries with very high debt ratios, as suggested by the Commission.

The Council also outlined a number of steps to improve the governance of EU rules. It suggested closer co-operation between Member States, the Commission and the Council in the implementation of the Pact. It indicated the need to develop national budgetary rules and ensure that national parliaments are closely involved in the process. Finally, it called for reliable macroeconomic forecasts and budgetary statistics.

4.2 A first evaluation of the reform

These changes had a mainly sceptical reception. Some commentators argued that, given the host of exceptions to the 3% rule and the larger discretion left to the Council, the Pact is *de facto* dead (Calmfors, 2005, Buiter, 2005). Even those traditionally critical of the old SGP, while appreciating the better balance between fiscal discipline and flexibility, viewed the reformed Pact as excessively prone to opportunistic interpretations and not tackling the root causes of fiscal imbalances (Coeuré and Pisani-Ferry, 2005).

In reviewing the debate on the SGP, Buti et al. (2005) highlight four critical issues that any effective reform of the Pact should tackle: (a) overcoming excessive uniformity, (b) improving transparency, (c) correcting pro-cyclicality, and (d) strengthening enforcement.

Overcoming excessive uniformity – The new SGP introduces some elements of country-specificity in both the preventive and the corrective arms of the Pact. The close-to-balance rule of the original SGP, interpreted as broadly balanced budgets in cyclically-adjusted terms, treated equally countries with different levels of public debt, implicit and contingent liabilities, and public investment needs.

In the early years of EMU, the only dimension along which countries were differentiated were the variability of the cyclical component of the budget balance. In the new Pact, the articulation of the MTO has been extended to other dimensions, such as the financial fragility of the country embodied in stock of public debt and – in the future - the threat to long term sustainability given by the implicit liabilities of pension systems, as well as the capacity of countries to 'grow out of their debt', by taking into account their potential growth (and therefore structural reforms which aim at boosting it).

The Council has taken a cautious approach by stipulating that, in order to safeguard the 3% deficit ceiling, the medium term target should never exceed a deficit 1% of GDP. If structural reforms entailing front loaded costs, deviations from the MTO are allowed, but only under narrow conditions. The new SGP introduces elements of country specificity also in the corrective arm of the Pact.

Whilst such changes may reduce excessive uniformity of the rules, they may in some instances increase the complexity of the rule, with negative implications for transparency and enforcement.

Improving transparency - The EU fiscal framework had been widely criticised for its lack of transparency. First, the deficit indicator as defined by ESA-95 does not provide a full picture of countries' public finance imbalances. Second, the debt indicator (gross financial debt at face value) allows targets to be achieved via operations which do not improve fiscal sustainability and tends to underestimate overall outstanding liabilities. Third, under the current system of national accounts, monitoring is hampered by delays in data provision and allows some manipulation of statistics with the implication that the whistle is often blown far too late or only when the true data eventually surface. Finally, the forecasts underlying stability programmes have frequently turned out to be optimistically biased.

The new SGP includes potentially important provisions leading to improved transparency, but also elements which work in the opposite direction.

In recent years, in order to meet the short term deficit targets, countries have frequently adopted one-off, cash-raising measures instead of making the necessary structural adjustment. The decision that compliance with the medium term target as well as with the minimum annual adjustment of 0.5% of GDP are to be assessed in *structural* terms, by netting out the estimated effect of the cycle and one-off measures, should lead to improved transparency.

The availability of high quality statistics and timely fiscal indicators still remain an issue. The new Pact acknowledges the importance of quality, timeliness and reliability of fiscal statistics and pledges to ensure the independence, integrity and accountability of both national statistical offices and Eurostat. The availability of better statistics should be complemented a more comprehensive surveillance of fiscal variables.

Overly optimistic forecasts that are common in some Member States can translate into higher than projected deficits, since government revenues quickly respond to changes in potential output whereas adjustments on the expenditure side normally require a lengthy process of political decision-making. The new Pact indicates that budgetary projections should be based on realistic and cautious macroeconomic forecasts.

While the above changes go in the direction of improving the quality and availability of fiscal indicators, others are likely to negatively affect the second aspect of transparency mentioned above, that is the possibility to easily assess compliance with the rules.

As to the corrective part of the Pact, the most notable amendment is the specification of so-called “other relevant factors” in the assessment of whether a deficit in excess of 3% of GDP can be considered ‘excessive’ in the sense of the Treaty. Such factors - ranging from the implementation of the Lisbon agenda and policies to foster R&D and innovation to the overall quality of public finances, from financial contributions to international solidarity to fiscal burdens related to European unification – may give countries easy escape roads in the case of deficits in excess of the reference value. While there is an important safeguard in the provision that any excess over the 3% deficit threshold should remain limited and temporary, encompassing such long list of factors, risks blurring the assessment.

The preventive part of the SGP has also become more complex. The Medium-term Objectives are no longer defined ex-ante. They are instead objectives that countries set themselves in their stability programmes on the basis of commonly agreed criteria which may evolve over time.

Correcting pro-cyclicality - It is widely recognised that the original SGP did not provide sufficient incentives for countries to run prudent fiscal policies in good times with the result of having their room for manoeuvre curtailed in bad times. The new agreement explicitly aims at correcting pro-cyclicality by emphasizing the importance of reliable macroeconomic forecasts, the commitment to step up consolidation in good times, relaxing the "exceptionality clause", making the timing for the correction of the excessive deficit a function of the prevailing cyclical conditions and foreseen the guarded possibility to repeat steps of the procedure in case of adverse shocks.

While these changes go in the right direction, one may ask whether they go far enough in terms of stick and carrots.

In order to step up peer pressure, a possible solution could be that of using the early warning procedure of the SGP not only in bad times when the deficit approaches the 3% ceiling, but also in good times when a significant divergence from structural targets is detected. The idea of an early warning procedure independent of the immediate danger of an excessive deficit is considered in European Commission (2004). However, the new SGP, while foreseen the possibility for the Commission to issue "policy advice" in this regard, did not accept this proposal.

Buti et al. (2003) and Sapir et al. (2004) have argued that the introduction of rainy-day funds may improve the incentives for a prudent fiscal behaviour in good times. These funds, which would be used in times of recession and replenished in upturns, might increase the incentive for governments not to waste the surpluses in good times and increase the room for manoeuvre in bad times. However, their establishment would imply a review of the current ESA accounting rules for computing budgetary statistics, so although interesting, such a move is not unproblematic.

Strengthening enforcement - A strong criticism of the Treaty and the old SGP is that enforcement is partisan: national authorities are supposed to apply the rules to themselves, thereby having strong incentives for collusion and horse-trading. As indicated in table 1, like in the case of transparency, the new Pact includes provisions which will strengthen enforcement and others which are likely to weaken it further.

As pointed out in Buti et al. (2003), enforcement is particularly problematic in the case of supra-national fiscal rules applying to sovereign countries. A way forward would be to enhance the national ownership of the rules so that there is a better chance that they become self-enforcing. In parallel, one should strengthen the role of the Commission in the enforcement of the SGP.

On the first count (national ownership), the new provisions concerning governance – notably the involvement of national parliaments - go in the right direction, but are overall modest. In particular, the suggestion to establish independent monitoring bodies at national level, which had been strongly advocated by Sapir et al. (2004) and mentioned in the initial proposals by the Commission (European Commission, 2004), was not accepted. On the second count (stronger role of the Commission), the new Pact does not introduce any significant change in the voting or the procedural arrangements. Evidently, the Council was not prepared to strengthen the authority of the Commission in the implementation of EU fiscal rules. On the contrary, provisions such as the considerations of "other relevant factors", by reducing transparency and increasing the possibility of collusion within the Council, risk working against an effective enforcement of the rules.

5 The reformed Stability Pact from a political economy perspective: renewed ownership or green light to collusion?

5.1 The SGP as a supranational rule

Maastricht *cum* the SGP was the EU response to the unsustainable budgetary developments of the previous decade. The choice of the EU to rely on a supranational rule had important implications[5]. By focussing on the budget deficit, the rule clearly aimed at fostering macroeconomic stability of the currency union rather than at tackling head on the negative effects of public finance developments on growth. The choice of the budget deficit as the variable constrained by the EU rule was not only due to its potential macroeconomic spillovers and its relatively simple monitoring and measure, but also because it is relatively neutral in terms of the social preferences of EU countries. This is obviously essential for a supranational rule which must fit countries with widely different levels of development, size of the public sector, preferences along the efficiency/equity frontier.

[5] For a more detailed analysis of the SGP as a supranational rule, see Buti et al. (2003).

In a (revised) Musgravian perspective[6], abiding by the SGP could help reining in the threat of unsustainability while regaining room for fiscal stabilisation. Seen instead through the lenses of Buchanan, the SGP, together with the pressure of tax competition in a single market, could eventually lead to lower public spending and a less intrusive role of public sector in the economy, thereby helping to tackle one of the root causes of Europe's growth problem. While preserving this logic, the reformed Pact also makes allowance for structural public finance reforms aimed at boosting growth.

5.2 Does the new SGP encompass the right political incentives?

Whether or not the new SGP will actually produce these potential effects depends on whether the new rules embody the right incentives for compliance. Table 3 compares how five conditions judged essential for the success of the Pact were fulfilled or not in the SGP 'mark I' and are likely to be met in the 'mark II' version[7]. Two scenarios for the new version are considered: an opportunistic 'collusive' scenario and 'genuine' adherence to the new rules.

Table 3 - The Old and the New Stability Pact: two readings

	Old SGP	New SGP: Collusion	New SGP: Genuine
1. Public visibility	High but fading	On the way to oblivion	Medium
2. Clear incentives	Blurred	Easier to get away with	Better rationale
3. Political ownership	Small MS	High deficit MS: DE+FR+IT	Germany and virtuous MS
4.Constraining calendar	CTB a moving target	MTO de facto never	MTO by the end of Stability programme
5. Collegial culture	Acrimony prevailed	Mutual back-scratching	New collegiality based on trust

Public visibility - The objective of meeting the Maastricht convergence criteria was the centrepiece of public finance strategies in many EU countries during the 1990s. Public visibility was greatly facilitated by the simplicity of the 3% of GDP deficit criterion which provided a clear signpost for economic policies regardless of the government political colour, especially in countries which entered the 1990s with very high deficits and

[6] In a modern perspective, the dimension of sustainability is added to the original 'Musgravian triangle'. Sustainability is closely linked to the goals of efficiency and stabilisation. After the shocks of the 1970s, ensuring cyclical stabilisation has been broadened to preserving overall macroeconomic stability.
[7] See Buti and Giudice (2002) and Buti and van den Noord (2004b).

looming unsustainability threats. The simplicity and the (largely) unambiguous definition of the fiscal requirements – especially that concerning the budget deficit - allowed an effective monitoring on the part of the European Commission which played the role of external agent entrusted with the correct interpretation and implementation of the Treaty criteria. High visibility, together with easy monitoring, had also been one of the reasons for preferring numerical targets over national procedural rules. Relative to a simple deficit ceiling, the close-to-balance-or-in-surplus rule of the SGP enjoyed lower visibility. The fact that in the reformed Pact, the MTO are set by national authorities (albeit within the range agreed upon by the Council) gives a better chance of renewed visibility under a genuine implementation of the new rules. However, a collusive approach by national governments would relegate the Pact to the backburner and, eventually, it would fade into oblivion.

Clear structure of incentives - The Maastricht public finance requirements very clearly laid out rewards and penalties. Meeting the convergence criteria enabled budgetary laggards to join the virtuous countries in the new policy regime, while failing to comply carried the penalty of exclusion from the euro area. Market incentives were also crucial. Countries with high deficit and debt levels which adopted a credible adjustment programme were able to enjoy a reduction in interest rates which helped lower their public finance imbalances. The structure of incentives changed entirely with the entry into the euro area: the market incentives were reduced with the convergence of interest rates and the carrot of entry was eaten while the stick of exclusion was replaced by the threat of uncertain and delayed sanctions under the SGP. The experience of the early years of EMU showed that the Council was not ready to use the 'nuclear option' of pecuniary sanctions, especially vis-à-vis large countries. The new Pact offers easier ways out, for instance by allowing repetition of the various steps of the EDP procedure. However, if genuinely applied, its stronger economic rationale may in fact increase peer pressure on fiscal delinquents.

Political ownership - The whole debate on the fiscal requirements of EMU reflected Germany's concern with fiscal discipline: both the Maastricht fiscal criteria and the SGP clearly bear Germany's fingerprints. Strong macroeconomic stability came to be regarded as an essential pre-condition for Germany to accept merging monetary sovereignty into a single currency. After 2000, due to German economic difficulty, political ownership of the SGP shifted towards smaller countries with structural surpluses which, although numerous, have a relatively small weight in the euro area. This was sufficient to keep the pact alive, but weakened the enforceability of the rules, especially vis-à-vis large countries. Germany holds once again the key to a rigorous implementation of the new rules. Renewed political ownership by Germany requires that it accepts a tight application of the rules to itself. Otherwise, high deficit countries would simply disregard the EU rules. Resistance by virtuous small member states would eventually be swamped in a collusive deal.

Constraining calendar - The Treaty set very clear deadlines for moving to the final stage of EMU. Countries wanting to join the first wave had no choice but to make the required consolidation effort to meet the convergence requirements. The SGP set very clear and short deadlines between the various steps of the excessive deficit procedure, but the 2003 November crisis over France and Germany led to a stalemate. However the real problem was that the close-to-balance requirement of the Pact had no specific timetable. This requirement, therefore, was treated like a moving target. The same fate might also fall upon the MTO in the new Pact if the collusion scenario materialises. On the contrary, countries would meet their MTO if the new rules are applied in earnest.

Collegial culture - During the run up to EMU, the convergence process facilitated the progressive emergence of a collegial stability culture among national and EU officials. This facilitated peer pressure between national authorities and enhanced the role and authority of the European institutions. In the implementation of the SGP, however, this climate of mutual trust was replaced by acrimony between the Council and the Commission, and between large and small countries. Under the reformed Pact, if collusion prevails, the more complex setting would favour mutual back-scratching by fiscal sinners (‘I help you now, you help me later’). On the contrary, a new collegial atmosphere based on trust would emerge under a genuine application of the new rules.

What is the probability that the new SGP is applied rigorously? According to most academic and policy commentators, the new rules bear the imprint of collusion as a birthmark. While a certain degree of scepticism is justified, one should not write off the SGP ‘mark II’ too quickly. At EU level, the reputational loss for the ECOFIN Council and, especially, the Eurogroup, not to talk of the Commission, would be enormous. At the national level, the key is held by large countries, especially Germany. It will not be long before the jury renders its verdict.

5. Conclusion: could Buchanan meet Musgrave again?

The paper has examined the role of fiscal policy in Europe since World War Two. It has shown that two phases prevailed. During the ‘Golden Age’ that lasted until the mid-1970s, Europe witnessed a “public finance” phase, when the three sides of Musgrave’s triangle seemed to reinforce one another, with no apparent trade-off between allocative efficiency, redistribution and stabilisation. During the next 30 years, Europe suffered a “public choice” phase, with increasing public deficits and trade-offs between allocative efficiency and redistribution in the manner foreseen by Buchanan, leading to declining growth performance.

By the end 1980s, several countries had adopted public finance rules and guidelines to attempt controlling their deficits, but they were often ineffective. Hence, the choice was made to set up rules at the EU level where, allegedly, “public choice temptations” could be more easily stemmed. The Maastricht criteria codified the imperative of consolidation as a condition for joining the euro area. As a complement to the Treaty rules, the Stability and Growth Pact aimed at making budgetary discipline a permanent feature of EMU.

The hope was that EU fiscal rules would help national governments find sort of a mid-point between the views of Musgrave and Buchanan. Abiding by the SGP would help solving the threat of unsustainability and regaining room for fiscal stabilisation in the perspective of Musgrave. At the same time, it was hoped that the SGP could eventually lead to lower public spending and a smaller role of the public sector in the economy, thereby helping to tackle one of the root causes of Europe’s growth problem in the perspective of Buchanan.

Clearly, the Stability Pact ‘mark I’ had a number of drawbacks, particularly in terms of asymmetric incentives and lack of a long-term view, which limited its ability to fulfil its role. The reformed Pact goes some way towards correcting such problems while retaining the original architecture.

However the question remains as to whether EU rules can succeed where national rules had failed. Our view is that EU rules can be helpful provided they are backed by national institutions and better enforced at the Community level.

A successful application of the Pact will require increasing political accountability at national level. This applies to the provisions concerning governance, namely the use of reliable forecasts and the stronger role of national Parliaments. More fundamentally, member states should set up independent national boards in charge of budgetary monitoring and assessment – including via the provision of unbiased forecasts (Jonung and Larch, 2006) - so as to complement and reinforce the role of the Community authorities in this area.

But, in the end, the major weakness of the old rules was poor enforcement mechanisms. Will the new rules be more effectively enforced? The fact that in the new Pact there is a greater margin for discretion but no independent enforcer may increase the incentives for collusion by the Council in subverting the implementation of the rules. If so, lack of enforcement would persist or even be aggravated. However, as the new Pact encompasses better economic rationale and may improve national ownership and fiscal transparency, there may be a better chance that it becomes self-enforcing.

While the reformed SGP has been greeted with scepticism in many academic and policy circles, it would be wrong to assume that it is bound to become irrelevant. First, the reasons why fiscal rules were adopted in a monetary union of many sovereign countries in the first place are still valid. The future enlargement of the euro area to Central and Eastern European countries actually strengthens the need for a common fiscal framework (Orbán, G. and G. Szapàry, 2004). Second, as shown by the debate on the reform of the Pact, no viable alternative to a credible supranational rule emerged, since all the other potential solutions came up against serious criticism of one kind or another. Third, many countries need sound fiscal policies leading to a reduction in debt levels also for purely domestic reasons – particularly the demographic shock which lies around the corner: an external anchor will continue to be useful. Finally, it is likely that, as soon as serious imbalances emerge in some countries threatening the stability of the euro area, the other euro-area members will step up the pressure for rigorous implementation of the rules.

The rigorous enforcement of the reformed SGP will, in the end, depend on politics. Better rationale *per se* of EU rules, echoing Musgrave’s public finance goals, will not suffice. Key in particular will be renewed ownership of the rules by key players and the full integration in their national policy framework. In the perspective of Buchanan, only to the extent that the perceived long term negative spillovers of fiscal misbehaviour in EMU outweigh the short term political costs of attempting to limit the partner countries’ room for manoeuvre will the new rules be rigorously applied. While the early experiences of implementation of the reformed SGP are encouraging, on the above question, which goes to the heart of supranational policy rules and coordination, the jury is still out.

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