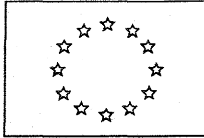

EUROPEAN COMMISSION
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TOWARDS A STABILITY PACT

(Note for the Monetary Committee)

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1. INTRODUCTION

The German Minister of Finance, Dr. Theo Waigel, presented in November a proposal for a "Stability Pact for Europe" ("Stabilitätspakt für Europa") to ensure budgetary discipline in the final stage of economic and monetary union. The text in German circulated to Ecofin ministers on 10 November 1995 was also accompanied by an unofficial translation into English.

The present note contains a first set of reflections by the Commission services on the stability pact proposal. Its various aspects - economic, budgetary, legal and procedural - are commented upon, and a preliminary examination is made of how such a pact can be put into practice in full conformity with the Treaty on European Union.

The note is intended as a contribution to the debate sparked off by the German proposal. It in no way attempts to set out the conclusions which the Commission may reach at the end of this period of discussion or to prejudge the preferred options of the Commission.

At this stage not all the aspects of the stability pact proposal have been subject to the same degree of scrutiny. In particular, the question of the appropriate scale of sanctions to be applied when budgetary limits are not respected has not yet been examined.

2. ECONOMIC AND BUDGETARY ASPECTS

2.1 THE IMPERATIVE OF BUDGETARY DISCIPLINE

The overriding concern of the stability pact is to provide the necessary conditions to ensure fiscal discipline in stage three of economic and monetary union. A sound budgetary policy, by supporting the anti-inflationary commitment of the European Central Bank, is essential to bring about the optimal policy mix for EMU as a whole and for the individual members.

While clearly stating that no re-negotiation of the Maastricht criteria for participation in the single currency is envisaged, the "stability pact" puts forward a number of proposals to implement a permanent fiscal discipline in stage three. Member States should enter a voluntary commitment encompassing the following elements:

- respecting the 3% deficit limit set in the Treaty, even in economically unfavourable periods, with exceptions being granted only in extreme cases;
- setting a medium term goal of 1% of GDP for the cyclically-adjusted budget deficit, thereby providing a safety margin of 2% of GDP under the 3% mandatory ceiling;
- reducing progressively the stock of debt even below the level of 60% of GDP indicated in the Treaty.
- keeping down the share of the public sector in the economy by, in particular, bringing down the rate of growth of public expenditure below that of nominal GDP;

According to the proposal, this set of commitments, by ensuring a reduction in the interest burden on public debt, would allow to focus government expenditure on public investment whilst gaining room for manoeuvre to limit future budget risks.

The imperative of budgetary discipline underlying the stability pact, both in the run up to EMU and beyond, is in line with the 1995 Broad Economic Policy Guidelines, approved by the Council in July 1995, which indicate that Member States should aim at bringing down their budget deficits below 3% of GDP as soon as possible, as a first step towards the medium-term goal of close to balance(1). As in the proposal for a stability pact, the Broad Guidelines stress that, in order to attain this objective, restraining public expenditure increases should be preferred, in many countries, to raising taxation.

2.2 THE BENEFITS OF SOUND PUBLIC FINANCES IN STAGE THREE

Maintaining budgetary discipline in stage three is an essential condition to reap all the benefits of the single currency.

The positive effects of sound public finances can be summarised as follows:

i) by fostering low and stable inflationary expectations, low budget deficits and debts will help in maintaining stable prices. They will also reduce the likelihood of or the economic costs of a possible market test of the anti-inflationary credibility of the newly established European Central Bank.

ii) a sound fiscal policy, by allowing a reduction in interest rates and "crowding in" private investment will lead to a higher growth of the capital stock in the medium and long run. This will help in shifting the economy onto a higher growth path and, by reducing the scarcity of capital, will be reflected in permanently lower real interest rates. As stressed in the recent report by the G-10 countries(2), since the Union has an important weight in the international economy, these developments will lead to lower interest rates world-wide, thereby contributing to step up growth at the global level.

iii) building higher public savings is important in order to face the budgetary consequences of demographic developments. The ageing of the population and the consequent rise in dependency ratios will inevitably put a heavy burden on social spending, which will be only partly compensated by higher private sector savings related to the possible spreading of private pension schemes. Furthermore, the contribution of private sector savings is likely to be eroded as a consequence of ongoing financial liberalisation which will tend to ease households' access to credit and insurance markets.

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(1) Outside Europe, the medium-term objective of eliminating the budget deficit has been introduced, e.g., in the United States' budget law.

(2) Group of Ten, "Saving, Investment and Real Interest Rates", October 1995.

iv) as stressed by the proposal for a stability pact, fiscal discipline, by curbing public debt ratios and hence reducing the interest burden on public debt, will allow to restructure government spending by devoting a higher share of public money to political priorities such as education. It will also help in reverting the downward trend in public investment which, in a number of Member States, has attained historically low levels.

v) lower deficit and debt levels create more room to cope with adverse economic events. This is particularly important once the single currency is in place because the accommodation of country-specific shocks will then to a higher decree rest with budgetary policy (and will also rely on the improved functioning of product and labour markets).

2.3 ECONOMIC IMPLICATIONS OF A UNIFORM NATIONAL BUDGET DEFICIT

The stability pact envisages a uniform medium-term target of 1% of GDP for the budget deficit across EMU as a clear commitment by Member States to permanently sound public finances.

Four factors have to be considered in assessing the economic consequences of such a requirement: the need to increase public saving in order to face the budgetary impact of ageing; the implications for the level of the primary surplus, especially in countries with high initial levels of public debt; the interaction between budgetary discipline and real convergence; and the necessary safety margin to cope with cyclical developments. These four factors are briefly examined below.

2.3.1 THE QUEST FOR HIGHER PUBLIC SECTOR SAVING

As pointed out in the previous section, there is a need to make room for higher public saving in order to cope with demographic developments. This applies particularly to certain economies which, in all likelihood, need to go beyond the 1% target by aiming at a balanced budget and possibly even at a cyclically-adjusted budget surplus.

Four countries, namely Denmark, Finland, Sweden and the UK, in line with the policy indications of the Broad Guidelines, have already introduced the objective of eliminating the deficit or moving to a surplus in their convergence programmes. Other countries will probably need to move in that direction.

2.3.2 THE IMPLICATIONS FOR PRIMARY SURPLUSES

A sustained budget deficit of 1% of GDP implies, under a "normal" rate of growth of nominal GDP of 5%, a long-run equilibrium level of the public debt of 20% of GDP. More importantly, with 1% budget deficit, even highly indebted Member States would be able to achieve a marked reduction in the debt ratio in a reasonable period.

As shown in Table 1 in Annex, under the assumption of a 5% constant yearly growth of nominal GDP, a sustained 1% budget deficit allows a country with an initial debt ratio of 120% of GDP to reduce that stock by almost 40 percentage points within ten years. Under the same assumption, a sustained budget deficit of 3% of GDP allows to bring down the stock of debt below 100% of GDP within the same time span.

The "degree of hardship" in bringing down and sustaining a 1% of GDP budget deficit - i.e. the required primary surplus - depends on the initial level of the stock of debt and on the interest rate-growth rate differential. For instance, under the assumption of a 2% interest rate-growth rate differential, a country with an initial stock of debt of 120% of GDP requires primary surpluses of between 5.5% and 7.0% of GDP for five to seven years to sustain a constant budget deficit of 1% of GDP (see Table 1). As a point of comparison the estimated primary budget surplus of Belgium and Italy in 1995 was 4.5% and 3.6% of GDP respectively[(3)].

Once the 3% of GDP deficit has been achieved, consideration will have to be given to the time span for the transition to the tighter deficit target (of say 1% of GDP as in the stability pact). Factors to be taken into account should include the initial level of debt: setting too short a period for countries with a high initial level of public debt, would require historically large primary surpluses[(4)]. However, joining the single currency, by resulting in the abolition of the exchange risk premium in interest rates, would clearly contribute to create the right conditions for bringing bring down the deficit below the 3% ceiling.

2.3.3 FISCAL DISCIPLINE AND REAL CONVERGENCE

Member States that are experiencing a catching-up process need comparatively higher levels of both private and public investment. Indeed, public investment can, in many cases, be complementary to private investment.

Higher government spending, especially in less favoured countries, can be accepted as long as it goes to investment to modernize their infrastructure or to measures aiming, for instance, at upgrading education and human resources. Furthermore, as shown in Annex Table 5, since catching-up countries anticipate a steeper growth pace, they can run relatively higher deficits without endangering the sustainability or the progressive reduction of their public debt.

Art. 104c(3) of the Treaty, by echoing the so-called "golden rule" of government financing[(5)], implicitly recognises both these elements by stating that, in assessing whether the budget deficit complies with the convergence criterion, it should be taken into account

(3) Commission's economic forecasts, November 1995.

(4) The Annex presents some numerical simulations in the case of a gradual reduction in the budget deficit (Table 3), as well as the data on the cyclically adjusted primary surplus in EU countries in periods of fiscal discipline since the beginning of the 1980s (Table 4).

(5) This rule is explicitly mentioned in Germany's federal state constitution.

"whether the government deficit exceeds government investment expenditure and (...) all other relevant factors, including the medium-term economic and budgetary position of the Member State". Hence, imposing very restrictive deficit/debt limits for those countries could either slow down the catching-up process or provide incentives for public authorities in less favoured countries to call for budget transfers via the EU budget.

Moreover, any implementation at national level of the policy indication in the stability pact proposal of progressively reducing the public expenditure ratio would need to take into account the below-average levels of expenditure in the catching-up countries and their greater public investment needs. It is clear, however, that it is paramount for less favoured countries to keep their public finances on a sustainable course in order to foster the confidence process underpinning domestic and foreign investment. For instance, as many public investment projects will never fully pay for themselves, a mechanical application of the "golden rule" may lead to excessive borrowing.

2.3.4 THE BUDGETARY ROOM FOR MANOEUVRE TO ACCOMMODATE CYCLICAL DEVELOPMENTS

The stability pact allows countries to let automatic stabilizers work during periods of weak conjuncture, as long as the budget deficit does not exceed the 3% ceiling. As the cyclically-adjusted deficit is set at 1% of GDP, the safety margin equals 2% of GDP.

However, in the past there has been quite a number of periods when the needed room for manoeuvre was larger than 2% of GDP. As shown by Table 6 in Annex, in years of economic slack during the period 1980-94, in one out of three cases, the cyclical component of the budget deficit in EU countries was larger than 2% of GDP and the variability of budgetary positions in smaller countries is considerably (over a third) higher than in larger countries. Smaller economies are more open than large ones, hence they are more affected by external developments. Over and above this, since smaller economies are usually less diversified, sectorial shocks are more likely to spread to the whole economy.

In EMU, with a single monetary policy, the shock absorption function of public budgets is likely to increase thereby widening the desirable safety margin, especially in the case of smaller countries. This may prove difficult in cases where the sustainable budget deficit is higher.

2.4 OVERALL ASSESSMENT

In the light of the above analysis of the proposal for a stability pact, the following general points can be made:

i) the need to ensure budgetary consolidation in Stage three of EMU beyond reaching the 3% Maastricht limit does not represent a novelty: it confirms the medium-term policy indication of the Broad Economic Policy Guidelines which has already been introduced in the convergence programmes of four Member States.

ii) A deficit target of 1% of GDP seems arbitrary: a medium-term goal of close to balance, as set in the Broad Guidelines, is preferable also to accommodate the budgetary consequences of negative cyclical developments.

iii) The simple budgetary projections presented in Annex show that, under a "normal" rate of growth of nominal GDP, a budget deficit of 3% of GDP or below allows countries with a high initial stock of debt to reduce consistently their debt ratio. Therefore, provided that the 3% requirement is satisfied, a commitment to achieving and sustaining in the medium run a budget deficit clearly lower than 3% of GDP, as stated in the Broad Guidelines under usual circumstances would imply respect of the debt criterion.

iv) The analysis developed above suggests that a certain differentiation in national medium-term budgetary targets may be desirable from an economic point of view. For example, different initial levels of public debt ratios and different requirements in terms of real convergence call for a flexible articulation of national budgetary positions within the deficit ceiling set by the Treaty. Furthermore, setting a uniform deficit target of 1% of GDP might make it more difficult for policy makers to convince the public of the need to persist in their consolidation efforts beyond the EMU-wide objective. Therefore, the budgetary objective mentioned in point ii) should preferably apply to EMU as a whole and not uniformly to each individual country. However, under these circumstances the question arises of how to make sure that a coherent budgetary stance at the EMU level is attained.

3. LEGAL AND INSTITUTIONAL ASPECTS

This chapter examines the various institutional and legal arrangements within the Treaty framework for developing a stability pact. Essentially, three broad legal/institutional options are available:

- exploit existing Treaty arrangements under Article 103 dealing with the broad economic policy guidelines and multilateral surveillance;

- exploit existing Treaty arrangements under Article 104c dealing with the excessive deficit procedure;

- develop a new arrangement. Legal measures could perhaps be adopted under Article 235. Alternatively, a stability pact might consist of a political agreement or commitment, for example in the form of European Council conclusions.

The focus here is on the first two options, i.e. how a stability pact could be implemented within existing Treaty arrangements under Articles 103 and 104c. The development of alternative arrangements under Article 235 or some form of political agreement is not

addressed in detail, but nonetheless a number of features are highlighted which any alternative arrangement would have to respect.

3.1 GENERAL TREATY PROVISIONS

There is no doubt that the Treaty provides for national budgetary policies to be a matter of common concern in EMU so as to ensure sound public finances. Article 3a of the Treaty specifies that close co-ordination of Member States' economic policies falls within the scope of the activities of Member States and the Community in EMU. Moreover, Article 3a states that both economic and monetary policies in EMU entail compliance with the guiding principle of sound public finances. As Article 3a contains a direct reference to Article 2 which specifies the objectives of the Treaty, it follows that the co-ordination of Member States' budgetary polices and the principle of sound public finances have general application. This is reaffirmed in Article 102a and in practical terms is spelled out in Articles 103, 104, 104a, 104b and 104c (and the associated Protocol on the excessive deficit procedure).

Although the focus of attention in any stability pact would be on constraints to be imposed on the level of public sector deficits, it should be borne in mind that Article 104 prohibiting monetary financing, Article 104a prohibiting privileged access to financial institutions and Article 104b establishing the no bail out rule are very strong Treaty provisions relating to national budgetary policy. Treaty provisions affecting national budgetary policy are listed in the annexed table.

3.2 ARTICLE 103: BROAD ECONOMIC POLICY GUIDELINES AND MULTILATERAL SURVEILLANCE

Article 103(1) requires Member States to regard their economic polices as a matter of common concern and to co-ordinate them within the Council. Article 103(2) specifies arrangements for the adoption of the broad economic policy guidelines and multilateral surveillance. The provisions are identical for participating Member States and those with a derogation, including Denmark and the United Kingdom.

The objectives of the proposed stability pact and Article 103 are shared given that Article 103(3) states that if the economic policies of a Member State are not consistent with the broad economic policy guidelines, *"or risk jeopardising the proper functioning of the economic and monetary union"*, then the Council, on the basis of a Commission recommendation, may adopt appropriate recommendations by qualified majority voting rules. The Council could decide to make these public again on the basis of qualified majority voting following a Commission proposal.

To date, this option has not been exercised. Such an act of public censure could be expected to impact on public opinion in the country concerned. It would certainly influence market perceptions possibly leading to a downgrading in the credit rating of the Member State in question. Therefore, significant indirect political and financial sanctions

are available to the Council under Article 103. It could therefore provide the legal base for those aspects of a stability pact where no direct financial sanctions are foreseen.

Article 103 could, however, not fully satisfy the stability pact proposal as it stands for several reasons. Firstly, although there can be some differentiation in policy recommendations between Member States, the decision-making under Article 103 encompasses all Member States and not just those participating in EMU. Secondly, measures taken under Article 103 could not be automatic. Thirdly, no direct financial sanctions are available.

3.3 ARTICLE 104C: EXCESSIVE DEFICIT PROCEDURE

3.3.1 A REVIEW OF TREATY PROVISIONS GOVERNING THE EXCESSIVE DEFICIT PROCEDURE

A detailed description of the existing arrangements for the excessive deficit procedure is required in order to isolate those elements of the proposed stability pact which could be incorporated under Article 104c. Governments under Article 104c are required to avoid excessive deficits in accordance with reference values established in the excessive deficits protocol.[6] It is a four-step procedure as follows:

- If a Member State fails to fulfil either the debt or deficit criteria, or if there is a risk that it will do so, the Commission shall prepare a report which shall take account of all relevant factors. Article 104c(6) requires the Council to decide by qualified majority whether an excessive deficit exists after having considered the observations of the Member State concerned. All Member States participate in this vote, including Member States with a derogation and the Member State concerned.
- Under Article 104c(7), the Council shall make recommendations to the Member State concerned with a view to bringing the situation to an end within a given period. Article 104c(13) determines the voting procedure[7], in which all Member States participate aside from the Member State concerned. These recommendations shall not be made public. However, the Council may decide to make the recommendations public if no effective action is taken within the period laid down. The same voting rules apply in this case.

It is at this stage that Articles 104c(9) and 104c(11) introduce additional measures applying to participating Member States if they persistently fail to implement the Council's recommendations. Member States with a derogation are exempt from these provisions under Article 109k(3) and consequently their respective voting rights are also removed under Article 109k(5).

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(6) Detailed rules and definitions are set out in Council Regulation EC/3605/93 of 22.11.93 adopted in accordance with Article 104c(14).

(7) "*... the Council shall act on a recommendation from the Commission by a majority of two thirds of the votes of its members weighted in accordance with Article 148(2), excluding the votes of the representative of the Member State concerned.*"

- Article 104c(9) states that "*the Council may decide to give notice to the Member State to take, within a specified time-limit, measures for the deficit reduction*" judged necessary by the Council. The Council may also request the Member State concerned to submit reports on its adjustment efforts. If the Member State concerned fails to comply with this Council decision, then Article 104c(11) allows the Council to impose a number of sanctions(8). Council decisions under Article 104c(9) and 104c(11) shall be taken by the Council on the basis of a recommendation from the Commission by a majority of two thirds of the votes of countries without a derogation excluding the votes of the Member State concerned.

The final step concerns the abrogation of an excessive deficit and re-introduces derogating Member States with a derogation to Council decision making.

- Article 104c(12) provides for the Council to abrogate some or all of the above decisions to the extent that the excessive deficit, in the view of the Council, has been corrected. Voting on the abrogation of Council decisions shall be undertaken on the basis of Article 104c(13), i.e. all Member States excluding the Member State concerned. Interestingly, this implies that Member States with a derogation will vote on the *de facto* abrogation of measures adopted under Articles 104c(9 & 11), even though they did not participate in the vote to impose these measures.

3.3.2 COMPARING THE EXCESSIVE DEFICIT PROCEDURE AND THE STABILITY PACT PROPOSAL

A key difference arises as regards the automatic nature of certain arrangements. Under the stability pact, a Member State would be automatically in breach of obligations once its government deficit passes 3% of GDP unless prior authorisation has been given by a Stability Council in the case of very exceptional circumstances. Under the excessive deficit procedure, a country is only in an excessive deficit after a Council decision. Moreover, 3% of GDP is considered as a reference value and gives the Council discretion to take account of all relevant factors.

A common feature is the ability to impose sanctions on countries participating in EMU, and notably the requirement to make a non-interest bearing deposit. However, under the proposed stability pact, they would be immediate, automatic and be imposed at a fixed level. It could be questioned whether the level of sanctions proposed in the stability pact respects the principle of proportionality established in Article 3b. Sanctions under the

(8) Four options are available: a requirement to publish additional information, to be specified by the Council, before issuing bonds and securities; an invitation to the EIB to reconsider its lending policy to the Member State concerned; requiring the concerned Member State to make a non-interest bearing deposit of appropriate size with the Community until the excessive deficit decision has been abrogated by the Council; the imposition of fines of an appropriate size.

excessive deficit procedure are only imposed after a country has failed to implement Council recommendations. In addition, the Council has a range of sanctions from which to choose, and retains discretion to set sanctions at an appropriate level.

In many respects, the institutional arrangements of the excessive deficit procedure and the proposed stability pact are similar. Membership of the proposed Stability Council would be limited to those participating in EMU, whereas the excessive deficit procedure provides an institutional framework involving all Member States, but only those participating in EMU can vote on giving notice to a Member State to take measures for deficit reduction (Article 104c(9)) and the imposition of sanctions (104c(11)).

Some scope exists within the Treaty for further developing the excessive deficit procedure. Article 104c(14) provides for the replacement of the Protocol on excessive deficits by the Council acting unanimously on the basis of a proposal from the Commission and after consulting the European Parliament and the ECB. However, it would not be possible to alter provisions in the Treaty itself: hence, it appears that the Council could not render sanctions automatic nor amend any of the voting procedures established in Article 104c.

3.4 ASSESSMENT ON LEGAL AND INSTITUTIONAL ASPECTS

The above examination leads to the following comments:

- all the Member States should play a full part in the definition of any new rules and procedures;
- new arrangements should neither contradict nor substitute the existing provisions of the Treaty;
- in some respects, decision-taking by the sub-group of Member States participating in EMU is already provided for in the excessive deficit procedure, and this has some similarities with the proposed Stability Council;
- a clarification in advance of how sanctions would be applied and their quantification could be considered as making the existing provisions of Article 104c more explicit;
- the automatic triggering and application of sanctions without going through the various steps of the excessive deficit procedure appear to be inconsistent with the Treaty; could this be handled by some agreement on when and at what speed the successive steps of the excessive deficit procedure would be implemented?

Most of the aims of the stability pact can be met by an effective use of the broad economic policy guidelines and by an accelerated implementation of the steps of the excessive deficit procedure. In order to define more clearly how these arrangements would work it would probably be useful to introduce secondary legislation based on articles 103(5) and 104c(14) of the Treaty (although voting procedures and Parliament involvement differ in these two cases).

PROVISIONS IN THE TREATY ON EU AFFECTING NATIONAL BUDGETARY POLICIES

	Content	Treaty provision	Institutional arrangement for implementation
1. Co-ordination (non binding)	Economic policy co-ordination	103(1)	Co-ordination in Council
	Broad economic policy guidelines	103(2)	Council Recommendation
	Multilateral surveillance	103(3)	Council meetings
	- monitoring of Community/Member States		
	- consistency of policy with guidelines		
	- overall assessment and (public) Recommendations	103(4)	Council Recommendation
	- inconsistency with guidelines		
	- jeopardising function of EMU		
	Rules adopted in accordance with Article 189c	103(5)	Council acting by QMV
2. Rules (binding)	No monetary financing	104	Court of Justice
	No privileged access	104a	Court of Justice
	No bail out	104b	Court of justice
3. Excessive deficit (binding)	Monitoring	104c(2)	Commission
	Report if	104c(3)	Commission report
	- violation of criteria		
	- risk of excessive deficit		
	Discussion of report	104c(4)	Monetary Ctte. (opinion)
	Existence of excessive deficit	104c(5&6)	Council Decision*
	Action against a Member States		
	- confidential recommendation	104c(7)	Council Recommendation**
	- public recommendation	104c(8)	Council Recommendation**
	- notice to a Member State	104c(9)	Council Decision***
	- sanctions	104c(11)	Council Decision***
	- abrogation	104c(12)	Council Decision **

* QMV of all Member States

** Two-thirds majority of all Member States weighted according to Article 148(2) except the Member State concerned

*** Two-thirds majority of all Member States participating in EMU weighted according to Article 148(2) except the Member State concerned

4. IMPROVING BUDGET DISCIPLINE AT THE NATIONAL LEVEL

Although Union level surveillance procedures and sanctions will have a role to play in enforcing budget discipline, of primary importance will be the establishing of a firm commitment to continued sound public finance at national level and the strengthening where necessary of national budgetary rules and procedures. It may be recalled that a provision in Article 3 of the Protocol on the excessive deficit procedure requires Member States to ensure that national procedures in the budgetary area enable them to meet their obligations as regards excessive deficits. There is growing evidence from academic studies that budgetary and legal arrangements impact on the sound management of public finances and that certain features are conducive to better control (see Box on "The role of national budgetary procedures" for a summary of some recent work). Experience with the convergence programmes has also highlighted weaknesses and helpful features in national systems.

Areas which appear to be in particular need of attention in a number of countries include:

- public expenditure planning and control: the parts played by the different actors involved; multi-annual approach; commitment to binding nominal targets, etc.;
- co-ordination between the different levels of general government;
- monitoring and correction mechanisms: reinforced regular and transparent monitoring (c.f. Swedish convergence programme); linkage with corrective measures; scope for pre-specified automatic measures when slippage in deficit identified.

Many changes have already been introduced in recent years and these experiences need to be shared more fully between Member States. In the end achieving stable public finances will depend on the successful self-discipline of Member States. However, this is an area where subsidiarity applies, there are sensitive issues concerning parliamentary sovereignty over budgetary policy, and in any case no single model would be appropriate given the diversity of historical and constitutional backgrounds.

More work is required in this area to deepen the analysis and bring forward concrete proposals at national level. Self-discipline by Member States (including effective correction mechanisms) will be of crucial importance in order to achieve the underlying objectives of the stability pact. A possibility is that countries would agree as part of the pact to complete a review of their national budgetary systems and put forward proposals for reform where appropriate. Could the Monetary Committee embark on an exercise based on Member States' own analyses on the scope for reinforcing national budgetary rules and procedures?

THE ROLE OF NATIONAL BUDGETARY PROCEDURES

Experience of several countries indicates that budgetary procedures, i.e. the rules according to which budgets are drafted by the government, amended and passed by the parliament, and implemented by the government, are important for attaining and maintaining fiscal discipline. This can be achieved by two types of (not mutually exclusive) institutional commitment technology: **commitment to a numerical target** or **commitment to an appropriate procedure**. The underlying considerations are explained in great detail in a study by von Hagen and Harden (1994)[9].

According to the study, the setting of an ex ante binding numerical target limits the scope for excessive spending already early in the budgeting process and also prevents scope for amendment at later stages. In order to strengthen the link between current decisions and future outcomes of the budget process it would also be useful to adopt and adhere to multi-annual expenditure targets[10].

A fundamental rule to be applied seems to be that conflicts over resources should be resolved through the budget process. The budget should neither be bypassed, nor reduced to a mere record of prior commitments. Conflicting claims and decisions between them should be clearly identified and made. Moreover, the budget process should be structured so as to ensure that there is a clear accountability for the annual budget deficit.

According to von Hagen and Harden, specific features contribute to limiting public deficits in the course of the budgeting process. Within the *government*, the distribution of powers between "spending" ministers on the one hand and the prime minister and finance minister on the other is very important. If the latter have a position of strategic dominance, deficits are likely to be smaller as they are generally more concerned with the collective interest than "spending" ministers who are interested in expanding the resources of their own ministries. In Germany, the finance minister has a predominant role in drawing up the budget plan. He can change spending proposals of other ministers without their agreement. If the latter demand a decision of the government in particularly important matters, the finance minister has a right of veto. In the *parliamentary stage*, the balance of powers between government and the parliament plays a key role. Representatives of constituencies are subject to the same conflict between collective interest in social efficiency of public expenditures and the individual interest in maximising the net benefits for particular constituencies. Hence, the bigger the scope for amendments by the parliament, the higher is the risk of excessive deficits, unless there is a commitment to finance all additional spending. (However, such a commitment must actually be enforced. In Italy, for example, a formal commitment exists but it has not been applied in practice.) During the *implementation* phase of the budget, two conflicting forces become important: the degree to which the budget law binds government's actions during the fiscal year, and the degree of flexibility to respond to unforeseen events. If the budget needs modification at this stage, there is a risk of increasing the deficit. Again, spending ministers are more likely to give in to demands for increased expenditures and are more prone to overrun the limits set by the budget law than the prime minister or finance minister and should, hence, only have limited powers.

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(9) See von Hagen, J. and I. Harden (1994), National budget processes and fiscal performance, in: European Economy, Reports and Studies, No. 3, pp. 311-418. The authors also provide empirical evidence that countries using such commitment technologies have systematically lower deficits and public debt levels relative to GDP than others

(10) While some kind of multi-annual planning exists in a number of Member States, they are generally not binding and the deficit is not the target variable.

The above considerations have only dealt with budgetary discipline at the level of central government. However, public finances at lower government levels also play a decisive role for the size of the general governments' deficit. The institutionalised budgetary co-ordination in the German federal system provides a good example. On the one hand, there are clear budgetary procedures and principles (e.g. that all territorial authorities are obliged to present plans for revenues and expenditures in a medium-term framework also consistent with macro-economic needs), on the other, the German fiscal constitution clearly determines the distribution of government tasks and their financing between the government levels. A more recent example is Belgium. Due to the federalisation and the decentralisation of decision-making in 1988, it became necessary to set up mechanisms to guarantee the co-ordination and overall consistency of fiscal policies. To this end, the "Conseil Supérieur des Finances" (CSF) was created to assess the fiscal positions of the general government and of its sub-sectors.

While fiscal decentralisation involves the risk of the generation of excessive deficits at lower government levels, the dangers of centralisation should, however, not be neglected. Persson and Tabellini[11] show in a political economy model that the latter generates more local public goods (i.e. higher public spending) than a decentralised system. Lower government levels generally know better the preferences of their citizens, and the scope for rent-seeking tends to be smaller. If the financing of local public goods lies in the responsibility of those who take the decision on their provision, the danger of excessive deficits is also limited.

(11) Persson, T. and G. Tabellini (1994), Does centralization increase the size of government?, in: European Economic Review, Vol. 38, pp. 765-773.

5. ELEMENTS OF A COMMUNITY PROCEDURE FOR THE APPLICATION OF A STABILITY PACT

The framework proposed by the stability pact would seem to imply some strengthening of co-ordination, commitment and monitoring procedures at Union level. The interplay between, on the one hand, the setting of objectives and the taking of measures at national level and, on the other hand, the coordination of economic policies (especially in the budgetary field) at Union level needs to be reinforced. Elements that should probably be present include:

- a medium-term perspective: first, for those Member States entering EMU with deficits close to the 3% of GDP limit, to cover the transition towards the medium-term objective; and second, because in practice actual budget balance results will fluctuate around the desired medium-term path;
- sufficient flexibility to accommodate country-specific differences while at the same time ensuring respect of the budgetary disciplines of the Treaty (e.g. it may be considered appropriate by some countries to aim at government surpluses in the medium term);
- scope for greater interplay and feedback between the EU level institutions and the setting of policy goals at national level;
- monitoring systems that provide early warning of potential serious deviations from medium-term objectives and of the risk of breaching deficit limits;
- some form of pre-commitment by Member States before their Union partners to corrective mechanisms to be applied when budgetary developments are moving off track.

These desirable features would seem to imply:

- regular statements by Member States of their medium-term budgetary strategy: in effect these might be medium-term budgetary "stability programmes", which would be successors to the convergence programmes;
- some assessment of the appropriateness of the overall budgetary stance for the EMU zone implied by the positions adopted by the individual Member States (e.g. is overall balance on the way to being achieved?);
- some consultation procedures at EU level which would mean that the national policy statements were not already "set in stone" when they were presented, but which allowed for some amendments to be introduced to meet Council concerns before such "stability programmes" were fully endorsed by the Council; such an endorsement would thus be much stronger than the present taking note and welcoming of the present convergence programmes;
- development of more transparent monitoring, especially at national level but also at EU level;
- pre-specification of spending curbs or tax increases to be introduced when the cyclically-adjusted deficit departs significantly from medium-term path.

6. CONCLUSIONS

The foregoing discussion raises many issues and uncovers a number of uncertainties on which the comments of Committee members are invited and to which they will no doubt wish to add their own points. The stability pact proposal stems from the need not only for each Member State to achieve sound public finances before participating in EMU but also for strict budgetary discipline to be maintained once in EMU; to this end the pact proposal in effect suggests a fuller specification and reinforcement of the relevant provisions of the Treaty and of existing practices for economic policy co-ordination.

A consensus already appears to exist that:

- the requirements for participation in EMU (either in the first group or at a later date) should in no way be changed;
- more generally, any new arrangements should be fully consistent with the existing Treaty and no amendment of the Treaty should be envisaged in this respect.

Maintenance of sound public finance positions in stage three of EMU will require a strengthened commitment from individual Member States. In particular, respect of the 3% of GDP limit for the government deficit in all but exceptional circumstances will imply aiming in the medium term for a government balance considerably stronger than this reference value limit, because of cyclical fluctuations and other shocks; moreover, there are additional sound economic reasons for adopting such a policy stance. However, in the light of the discussion in the earlier parts of this note, does the Committee agree that:

- the government deficit/surplus should be the main operational objective; seeking to impose an additional constraint on the gross debt ratio appears to be superfluous, as permanently keeping the deficit below 3% of GDP would ensure a downward trend in the debt ratio to well below 60% of GDP;
- the medium-term objective of a budget position close to balance is appropriate for the Union as a whole (as already set in the Broad Economic Policy Guidelines), but some differentiation for individual countries may be desirable from the economic point of view ; however the question of how to attain a coherent budgetary stance at EMU level requires further consideration;
- a reinforcement of self-discipline at the national level will be required, based where necessary on a strengthening of national budgetary rules and procedures;
- changes may be needed in the way medium-term budgetary plans are developed and implemented and in the way they are handled and endorsed at Union level (national "stability programmes"?).

Discussion is also invited on the way in which Union-level procedures could be further developed so that they would act as a more effective deterrent against national budgetary indiscipline. In particular:

- should the way in which sanctions are to be applied under Article 104c(11) be pre-specified and quantified?
- given that the automatic application of sanctions once a country exceeds the 3% of GDP deficit limit does not seem to be compatible with the Treaty nor desirable in all cases from an economic point of view, how can the steps already foreseen in the excessive deficit procedure for the third stage of EMU be speeded up and applied incisively?
- can the proposed Stability Council be considered as a formation of the Ecofin Council in which certain decisions are only taken by EMU participants, as already provided for in some of the steps of the excessive deficit procedure?

ANNEX

Government deficit, as a share of GDP, d_t, can be written as:

$$(1) \quad d_t = b_t - \frac{b_{t-1}}{1+y}$$

where y is nominal GDP growth (assumed constant).

The primary surplus, f_t, is defined as:

$$(2) \quad f_t = - d_t + \frac{i}{1+y} b_{t-1}$$

where i is the (constant) nominal rate of interest on government bonds[12]. If d_t is constant or is set to follow a pre-determined path, f_t needs to be set at the appropriate level each period in order to fulfil (2).

Although, for given levels of the budget deficit, the interest rate does not influence the speed of debt reduction, it affects the "degree of hardship" in bringing down the level of debt, through the required level of primary balance.

Attaining and sustaining a certain budget deficit implies different efforts according to the initial level of debt and the assumption of the interest rate-growth rate differential.
Tables 1 and 2 present some calculations concerning the behavior of the stock of debt and the required primary surplus in the case of a country with a high initial level of public debt (120% of GDP), under the assumption of a 2% interest rate-growth rate differential, if the budget deficit is kept constant at 1% and 3% of GDP, respectively. Table 3 presents a scenario of gradual reduction over 4 years of the budget deficit from 3% to 1% of GDP, under the same assumptions on the interest rate-growth rate differential.

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(12) It goes without saying that the following numerical simulations have only an illustrative purpose and by no means should be taken as "realistic" projections. In particular, the assumption of exogeneity of the interst rate -growth rate differential is highly restrictive. The real rate of interest is exogenous if there exists perfect substitutability between government debt and real assets or, in an open economy, between public debt and assets denominated in foreign currencies. The real growth of GDP is exogenous if the so-called Ricardian equivalence holds. Nominal variables are constant if we assume that the demand for money is "quantitative" and money supply grows at a steady rate.

A sustained budget deficit of 1% of GDP allows a much faster reduction of the stock of debt. However, even when it is attained gradually over a number of years, it implies historically high levels of primary surpluses (see Table 4).

Table 5 presents the same simulations under the assumption of a higher growth rate of GDP (6% instead of 5%), as one would anticipate in the case of countries experiencing a catching up process.

For a given level of budget deficit, this leads to a faster reduction in the debt ratio, allowing, at the same time, a slightly lower primary surpluses (compare Table 2 and Table 5). It can be shown easily that, for a given initial level of debt of 120% of GDP, a 1% lower interest rate-growth rate differential allows a sustained 1% higher budget deficit without affecting the time profile of public debt: Under the assumptions: i=7%, y=5% and d=2%, after ten years the debt ratio is reduced from 120% to 90% of GDP. The same stock of debt is attained under the assumptions: i=7%, y=6% and d=2%[13].

(13) Notice, however, that the equilibrium level of the debt ratio is not the same. It corresponds to 42% of GDP in the first case and 53% of GDP in the second case.

Table 1

REDUCTION OF PUBLIC DEBT
ASSUMING A CONSTANT BUDGET DEFICIT OF 1% OF GDP

bo	120%
i	7%
y	5%

time	b(t)	f(t)	d(t)
1	115%	7.0%	1.0%
2	111%	6.7%	1.0%
3	107%	6.4%	1.0%
4	102%	6.1%	1.0%
5	99%	5.8%	1.0%
6	95%	5.6%	1.0%
7	91%	5.3%	1.0%
8	88%	5.1%	1.0%
9	85%	4.9%	1.0%
10	82%	4.7%	1.0%

bo = initial level of public debt (% of GDP)
b = level of public debt (% of GDP)
d = budget deficit (% of GDP)
f = primary surplus (% of GDP)

Table 2

REDUCTION OF PUBLIC DEBT
ASSUMING A CONSTANT BUDGET DEFICIT OF 3% OF GDP

bo	120%
i	7%
y	5%

time	b(t)	f(t)	d(t)
1	117%	5.0%	3.0%
2	115%	4.8%	3.0%
3	112%	4.6%	3.0%
4	110%	4.5%	3.0%
5	108%	4.3%	3.0%
6	106%	4.2%	3.0%
7	104%	4.0%	3.0%
8	102%	3.9%	3.0%
9	100%	3.8%	3.0%
10	98%	3.6%	3.0%

bo = initial level of public debt (% of GDP)
b = level of public debt (% of GDP)
d = budget deficit (% of GDP)
f = primary surplus (% of GDP)

Table 3

REDUCTION OF PUBLIC DEBT
ASSUMING A GRADUAL REDUCTION IN BUDGET DEFICIT

bo	120%
i	7%
y	5%

time	**b(t)**	**f(t)**	d(t)
1	117%	5.0%	3.0%
2	114%	5.3%	2.5%
3	111%	5.6%	2.0%
4	107%	5.9%	1.5%
5	103%	6.1%	1.0%
6	99%	5.9%	1.0%
7	95%	5.6%	1.0%
8	92%	5.4%	1.0%
9	88%	5.1%	1.0%
10	85%	4.9%	1.0%

bo = initial level of public debt (% of GDP)
b = level of public debt (% of GDP)
d = budget deficit (% of GDP)
f = primary surplus (% of GDP)

Table 4

BUDGETARY POSITIONS IN PERIODS OF FISCAL DISCIPLINE: BUDGET DEFICIT LOWER THAN 3% OF GDP IN THE 1980'S

	d	d^c	f	f^c
Germany (1983-90)	-1.6	-0.7	1.3	2.0
France (1984-91)	-2.1	-0.0	0.7	0.7
United Kingdom (1985-91)	-1.6	1.2	2.3	1.1
Denmark (1985-92)	-0.3	0.5	7.7	7.2
Ireland (1989-95)	-2.3	-0.0	4.6	4.7
Austria (1988-92)	-2.5	0.4	1.6	1.2
Finland (1980-91)	3.0	1.0	4.5	3.5
Sweden (1986-91)	2.5	2.0	8.3	6.3

d = net lending (+) or net borrowing (-) of general government (annual average)
f = primary surplus (+) or deficit (-)
"c" suffix: cyclically-adjusted variables

Table 5

REDUCTION OF PUBLIC DEBT ASSUMING A CONSTANT BUDGET DEFICIT OF 3% OF GDP

bo	120%
i	7%
y	6%

time	b(t)	f(t)	d(t)
1	116%	4.9%	3.0%
2	113%	4.7%	3.0%
3	109%	4.4%	3.0%
4	106%	4.2%	3.0%
5	103%	4.0%	3.0%
6	100%	3.8%	3.0%
7	98%	3.6%	3.0%
8	95%	3.4%	3.0%
9	93%	3.3%	3.0%
10	90%	3.1%	3.0%

bo = initial level of public debt (% of GDP)
b = level of public debt (% of GDP)
d = budget deficit (% of GDP)
f = primary surplus (% of GDP)

Table 6

CYCLICAL COMPONENT OF BUDGET DEFICIT (1980-94)

	large countries[4]	small countries[5]	EUR 15
Average cyclical component[1] *(% of GDP)*	-1.1	-1.2	-1.2
Maximum (negative) cyclical component *(% of GDP)*	-2.8 (UK)	-5.6 (SF)	-
Frequency[2] of *c <= -2% of GDP*	8%	11%	10%
Adjusted Frequency[3] of *c <= -2% of GDP*	27%	38%	34%

c = cyclical component

1) average of the cyclical components being negative
2) number of observations of cyclical component being lower than -2% of GDP within the 15 years considered
3) number of observations of cyclical component being lower than -2% of GDP for the number of years in which GDP growth < trend growth
4) Germany, Spain, France, Italy, United Kingdom
5) EUR 15 without large countries (see 4))