Assessing the 2005 Growth and Stability Pact Reform: A New Fiscal Policy Rule for the Euro Zone Is Required

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Abstract

This paper analyzes the 2003 and 2005 Growth and Stability Pact reforms in the light of the 2008 financial crisis and national counter-cyclical fiscal policies followed in the euro-zone since then. It uses the Kopits-Symanski (1998) fiscal policy rule model in order to assess the evolution of fiscal governance before and after the reforms. Most of the characteristics of the model suffered sharp deteriorations: precision, simplicity, consistency and strong executive power, leading to a final conclusion of a better post-2003 GSP but a worse post-2005 GSP, the issue of the penchant of euro zone members for free rider behaviour requiring particularly strong executive power and coercive capacities. Because of degrading fiscal governance since 2005, the euro zone lacks a proper tool to back monetary policy and to follow long run sustainable growth because of increasing debt default risk among its members.

Keywords: Growth and Stability Pact, Euro zone governance, Fiscal policy rule

1. Introduction

The economics of European integration since 1999 imply a centralised monetary policy with decentralised fiscal policies supervised by a supranational fiscal rule: the Growth and Stability Pact. Aimed at progressive diminution of the public debt thanks to limited budget deficits, the coordinated fiscal policies are supposed to allow monetary policy to be set according to similar fiscal and debt situations among euro zone members in order to allow a better inflation targeting and perform a sounder interest rate policy to sustain a stable and balanced exchange rate of the euro.

Yet the GSP has been reformed in 2003 and 2005 with the immediate assessment that the modifications were giving the EU members more room for manoeuvre in their structural reforms. The EU members did not use the new GSP to stimulate reform but to, for some of them, follow pro-cyclical fiscal policy while conjuncture was good and increase their structural budget deficit.

The 2008 financial crisis has shown that such a policy was not sustainable even on the medium run for most of the Mediterranean euro zone members and Ireland: debt has increased, so have structural budget deficits and overall budget deficits(Note 1), reforms have been postponed (until then) and long-run interest rates have taken off, creating further pressure over debt' service and sustainability.

These considerations tend to show that the GSP' 2005 reform has been performed against common sense and economic efficiency, easing the development of a free-rider behaviour. Still, a closer look at European data of debt and fiscal deficits is required over the period 1997-2010 to establish an empirical link between GSP reforms and poorer national fiscal policies and a theoretical approach, thanks to the application of the Kopits and Symansky model (1998) on the reforms, to give a definitive conclusion over the core European governance GSP issue and propose a new model that would link both flexibility and discipline.

2. The Growth and Stability Pact in its original form

The coordination of national fiscal policies by the Growth and Stability Pact, extension of the Maastricht criteria for candidates to EMU enlargement, has been developed by the Dublin European Council in December 1996 and formally launched by the Amsterdam European Council in June 1997. Designed to promote a further step on control over national public finance, it had the objectives to prevent from excessive fiscal deficits and to progressively diminish the level of national debts in the European Union.

The original – Dublin GSP form in the Treaty of the European Union specified that(Note 2):

- Fiscal deficits were not to be higher than 3% of GDP unless the excess was limited or temporary and exceptional,
- Public debts were not to be higher than 60% of GDP unless the excess was regularly diminishing.

The original form of the Growth and Stability Pact leaves no place for interpretation: active national fiscal policies are not desired, discretionary fiscal policies needing to remain neutral. The third phase of the European Monetary Union,

the euro, implying an improvement of the efficiency of fiscal policy, the GSP was particularly designed for euro zone members.

The application of the GSP was therefore as follows:

- According to Art. 122.3 of the European Union Treaty, the GSP dispositions were not applying to non euro zone members ; the 2005 reform enlarging the application to the members of the Exchange Rate Mechanism 2 (Note 3),
- According to Art. 5 of the Treaty annexed protocol, the United Kingdom is not part of GSP members (Note 4).

2.1 Fiscal deficits

The European Union Treaty precises that fiscal deficits superior to 3% of GDP are considered as excessive and therefore must be avoided. (EC) N°1467/97 also precises that exceptional and temporary excesses must come from unusual circumstances beyond the member states wishes with considerable effects over fiscal balance, or from a serious economic recession.

The European Commission has specified that by serious economic recession it must be understood a yearly contraction superior to 2% of GDP in real terms, but lower yearly contractions could also be considered as exceptional as long as the recession is sudden and opposite to normal trends. In such a case, the minimum contraction must be superior to 0,75% of GDP on a yearly basis.

Despite of theses precisions on exceptional circumstances, the GSP suffers a deep handicap in the low definition of factors that are taken into account in the determination of 'exceptional deficits' where euro zone members could beat about that weakness not to enter into an excessive deficit procedure.

If fiscal deficits are higher than what GSP fiscal rules require, correction mechanisms are then supposed to be launched: a precise calendar is set to respect rules and penalties are imposed by the Commission. These rules specify that the excessive deficit must be brought down in a single fiscal year otherwise penalties are set. The Council makes recommendations to respect the criteria and reforms must be implemented in the next four months after which, if the member does not follow these recommendations, they are publicly pronounced and an extra month is given to set the required reforms. Again, if two months pass without any new fiscal policy aiming at bringing down the excessive fiscal deficit, the Council can then set penalties.

With particularly volatile world economic conjuncture since 2000, it remains difficult to assess with precision the degree of participation of the GSP to better fiscal balances among euro zone members from 1997 to 2000 and between 2004 and 2007. Still, fiscal deficits tended to decrease until 2007 (Figure 1.) where the GSP proved to be unable to prevent sharp increase of fiscal deficits in several members, among which Spain, France, Ireland, Portugal, Greece and Italy.

Penalties for excessive fiscal deficit can be of different natures depending on the steps of the procedure.

- A deposit without interests between 0,2 and 0,5% of GDP depending on the degree of excessive fiscal deficit,
- An obligation of extra publications for government bonds issues,
- Partial access refusal to the European Investment Bank loans.

After two years, if the excessive fiscal deficit has still not been absorbed, deposits could be transformed into effective penalties, implying for the member states that they have, on overall, three years to shift their fiscal policy before any real sanctions. Ultimately and in the meantime, penalties are much more vexatious measures compared to efficient governance tools, even if they would generate an increase of long-run interest rates with the publication of data that prove to the market that fiscal policy is problematic.

Thus, the GSP remains poorly credible because of the time left to member states to modify their fiscal policy and respect the fiscal balance criteria. Despite the particularity of the 2008 financial crisis, the fact that all the euro zone members do not respect anymore the criteria since 2009 is clearly a proof of imperfection; the fact that even during positive world economic conjuncture such as in 2004-2007 some members maintained their poor fiscal policies is however not only a case for imperfection, but also inefficiency.

2.2 Public debt

The other criteria of the GSP is the level of public debt. Despite the fact that it is usually less covered by economic literature compared to fiscal deficits, it remains, because of financial concerns over ageing population, immediate green growth obligations and further and further counter-cyclical fiscal policy needs with increasing number of economic and financial worldwide crisis, a major concern, not to say the most important criteria of the GSP.

The difference between the fiscal balance and the public debt criteria, which is limited to 60% of GDP, is that it has no penalties back-up to be enforced. This means that the Commission is actually limited, in the field, to review the statistics and publish them. As a consequence, this criteria is even less respected than the criteria on fiscal balance.

Favourable economic conjuncture allowed member states to diminish public debt between 1997 and 2002 after which, because of poor fiscal policy, debt increased again to reach in 2009 the 1997 level and will go over in 2010 (Figure 2.).

The fact that the GSP did not foresee any penalties in case of excessive public debt implies a situation where 2/3 of member states do not respect in 2009-2010 the criteria. What is ultimately even more problematic remains in the way Eurostat assess public debt: it does not take into account off-sheet incurring such as financial pressures from retirement scheme, which would imply much higher public debt figures for all euro zone members (Note 5).

The trend is clearly at an increase of public debt in the euro zone since 2001 with a zone average of 79,8% of GDP in 2010. The slight improvement of fiscal balance during the post 2001 crisis recovery did not improve enough the level of public debt, leaving the euro zone member states in a problematic fiscal position during the 2008 that could have been avoided. This tends to show that the member states did not diminish enough pro-cyclical fiscal policies during the 2004-2007 period when they should have performed sound counter-cyclical fiscal policies to decrease public debt and to improve their fiscal discretionary policy capacities to anticipate the next economic crisis.

The conclusion of this empirical study of the respect of the GSP criteria is therefore that the GSP did not reach its objectives and did not prevent some member states to behave as free riders that benefit from fiscal discipline by some member states and lower long run interest rates than what they should. Because of these considerations, the GSP seems to clearly lack a sounder coercive tool to address this fiscal free rider issue.

3. Current euro zone fiscal (lack of) governance – the reforms in practice

Having benefited from a small yet positive reform in 2003 and from a much significant but regressive reform in 2005, the Growth and Stability Pact did not enjoy a better constitution after 2005 to reach its goals.

- The Ecofin Council modified the GSP in March 2003 as it took into consideration the fact that some member states were following a pro-cyclical fiscal policy under positive economic conjuncture, increasing their public debt when they should have been able to decrease it. It therefore recommended to euro zone members that were not respecting the GSP to diminish their fiscal deficit cycle corrected by 0,5% of GDP each year. The implied risk of such a reform could have generated further pro-cyclical fiscal policy under negative economic conjuncture, but it was foreseen that a future complementary reform would settle this issue.
- The Ecofin Council modified again the GSP in March 2005 but not to complete the 2003 reform but somehow to lighten fiscal rules that were considered by member states as too restrictive. The reform was partly based on propositions from the European Commission in 2004 and entered into force in July 2005. Two settlements have been modified. N°1055/2005 modified N°1466/97 concerning fiscal policy coordination and N°1056/2005 modified N°1467/97 concerning the excessive fiscal deficit procedure.

One common aspect of both reforms is that they lack a further coercive tool for the criteria to be fully enforced. The 2005 reform has been made during a strong opposition against the GSP from the member states that were considering that it was too restrictive, not allowing them to perform discretionary fiscal policy when needed. The issue is actually that if the reforms created an ease in discretionary fiscal policy during negative economic conjuncture, it also had an impact in a further incapacity for the euro zone to prevent the member states to perform pro-cyclical fiscal policy during positive economic conjuncture.

As a consequence, while the GSP needed tougher rules and coercive capacities, the Ecofin decided to ease fiscal rules that were supposed to help the euro zone economic governance as the approved GSP modifications have been primarily oriented on weakening the excessive deficit procedure.

3.1 Reforms relative to the preventive GSP section

The most important reform is the precision of the medium-run objective for a fiscal balance close to equilibrium or positive. Indeed, the fiscal balance objectives would from now on be set from a debt ratio and potential growth. These objectives would go from a 1% of GDP fiscal deficit for small debt level member states and for whom potential growth is high and to a balanced budget or a positive balance for high debt level member states and for which potential growth is low. The new objectives were supposed to prevent fiscal deficits to go above 3% of GDP even during light economic contraction. On the other hand, no precision was given in case of strong economic recession.

It was also specified to euro zone member states and ERM2 participants that if they were not respecting the medium-run objectives, a diminution of their fiscal deficit by 0,5% of GDP yearly on average was replacing the demand for a diminution of their fiscal deficit by 0,5% of GDP yearly at minimum, this going clearly in a decrease of

fiscal rules. Still, it was also specified that further fiscal efforts were even more required when economic conjuncture is good, meaning when the out-put gap is positive. The problem with that positive change is that no quantification of 'further fiscal efforts' was given, leaving the euro zone members on their own interpretation to what extent a fiscal effort is enough to meet the new GSP fiscal rules.

It was also authorised not to respect neither the medium-run objectives nor progressive public debt diminution trajectory in order to perform structural reforms as long as the spread was remaining temporary. Here again, no definition was given to 'temporary'. The GSP was here clearly eased again as 'structural reforms' would have gained to be precisely defined to avoid renewed expansionist fiscal policies under positive conjuncture. Still, this reform could have proved to be an improvement if member states were using it for real structural reforms to decrease pressures over public finance. The example of Germany between 2004 and 2006 could be cited as a euro zone member that used the reform as an opportunity to perform sound and required reforms that had a strong impact over structural fiscal deficit.

The last issue for the preventive GSP section is that the medium-run objective is measured independently from conjuncture considerations: as LANGUENUS (2005) raised it, the attention was then focusing on structural fiscal deficit instead of fiscal balance corrected to conjuncture variations.

3.2 Reforms relative to excessive fiscal deficits

It is about the procedure for excessive fiscal deficit that the GSP has been the most modified: exceptional circumstances that were allowing member states not to suffer the procedure have been deeply enlarged. For instance, a noticeable and continued decrease of economic growth, yet remaining positive, could then be considered as exceptional circumstances not to respect the GSP.

The relevant factors that could justify a fiscal deficit superior to 3% of GDP have also been revisited. New factors were then taken into account, such as potential growth, level of public investments, debt sustainability etc. However, it was also precised that excessive fiscal deficit had to be limited in time and amount, without quantitative precisions, leaving again member states to perform their own interpretations.

Reaction and publication delays from the Commission have been extended, so has the delay to launch a procedure for excessive fiscal deficit, leaving more time for the member states to identify and perform the required structural reforms to respect the criteria. Despite of this, the Council confirmed the general principle that states that excessive fiscal deficits must be absorbed at the latest during the year they have been identified. The problem is that with the different reforms and more particularly the delays extensions, it proved to be almost impossible to enforce fiscal discipline during that period of time. As it will be shown later, a three years period, at minimum, would pass between the identification of an excessive fiscal deficit, the launch of the procedure and the excess indeed absorbed.

Finally, if the Council recognised the importance of taking into account the evolution of public debt and debt sustainability, it did nothing to give precisions in the debt ration at which public debt was to be diminished yearly.

3.3 The reforms assessed by the European Commission

The European Commission issued some doubts about the 2005 reform and identified several challenges for the future of the Growth and Stability Pact.

- It stated that the spirit of the reform had to be respected during positive conjuncture to restrain the increase of public debt and ultimately to decrease it until it reaches sustainable levels,
- It precised that a better governance in statistics issues had to be performed, focusing on quality, reliability and precocity of publications,
- It raised the issue that fiscal policies must be more linked to macroeconomic considerations to promote sustainable growth.

We shall remain prudent in the assessment of the 2005 reform. However, because of the fact that the GSP has been poorly respected before 2005, such an ease in its coercive capacities and such a space for interpretation with almost no quantified precisions, we can consider that the reforms did not address the issue of the euro zone fiscal discipline free riders. Still, a positive aspect of the reform is in the fact that some of the demands of several member states have not been accepted, among which a decrease of the Commission competences in the field and non-integration of several types of expenditures in the calculation of the level of fiscal balance.

The European Council has therefore favoured the search for the up-holding of national sovereignty over its fiscal policy at the expense of the European Commission and, more importantly, at the expense of fiscal governance and a better fiscal environment to back the monetary policy of the European Central Bank.

4. Applying the Kopits-Symansky model to the Growth and Stability Pact

Rules based fiscal policy frameworks are more and more considered in economic literature as benefiting to fiscal sustainability. Recent contributions to the debate between rules based or discretionary fiscal policy tend to give the upper hand to the first one, the 2008 financial crisis helping in the field to demonstrate that over-indebted economies can not make even medium-run fiscal efforts to counter the cycle. As far as we are concerned here, counter-cyclical policies prove to be required whatever the phase of the cycle, pro-cyclical policies being a much larger problem (DABAN and others (2003)) that must be closely monitored to prevent the debt to increase on the long run (Note 6). Still, the benefits of rules based policy in the field must be weighted against the loss of discretion capacities in the determination of the fiscal policy(Note 7).

To address the issue of the 2005 GSP reform, it is then required to base our assessment on a theoretical approach that would help us to quantify the evolution of the efficiency of the GSP before and after its reforms.

4.1 The Kopits-Symansky model

If FERRETI and MORIYAMA (2004) found a strong relationship between euro zone members' fiscal balance and the implementation of the Maastricht Treaty, BEETSMA and DEBRUN (2004) consider that fiscal rules must be relaxed to allow countries to perform structural reforms. In such circumstances, the 2005 reform would have been an improvement of the Pact as the German experience tends to show.

Still, DRAZEN (2004) considers that fiscal rules are helpful to build reputation and perform fiscal discipline as long as they are backed by sound procedural rules (Note 8) and SCHICK (2004) considers as determinant the role of political will in the success of any fiscal rule as long as strong procedural rules back the overall discipline attempt.

KOPITS and SYMANSKI (1998) developed a model that takes into consideration these factors and others to determine the degree of optimality of fiscal rules (Note 9).

- Precise definition: the indicators that are used as objectives and exemptions must be clear and precise to facilitate surveillance and avoid creative accounting,
- Transparency: the accounting, previsions and institutional arrangements must be clearly communicated to prevent from bad interpretations,
- Suitability: rules must be determined according to the objectives,
- Simplicity: rules must be simple to be well understood from governments and public, leading to taking into considerations nominal fiscal balance instead of structural fiscal balance,
- Flexibility: the system must be flexible to absorb exogenous chocks by, for instead allowing the automatic stabilisers to function,
- Consistency: fiscal rules must not go against already existing macroeconomic rules such as monetary policy,
- Strong executive power: fiscal rules must be backed by sound coercive capacities,
- Efficiency: fiscal rules must be sustained by efficient economic policies such as structural reforms.

As the authors precised it, no fiscal rules can combine all these elements, the objective being to assemble the most of them with the highest degree of fulfilment.

4.2 Application to pre and post 2005 GSP

Because of previous considerations on the Growth and Stability Pact before and after the 2003 and 2005 reforms, the application of the KOPITS and SYMANSKI model gives the following results (Table 1.).

The application of this model shows a clear improvement of the fiscal governance in the euro zone with the 2003 reform but a strong degradation with the 2005 reform, leading to the conclusion that the euro zone policy-mix would have been better off with no further modification after the 2003 reform. Still, some factors of the model seem to be of higher importance than others, such as flexibility, consistency, strong executive power and efficiency, where the differences between the original pact and the post 2005 pact are ultimately neutralising each other.

Using extended Kopits (2001) contributions on the subject and the three major lessons about optimal fiscal rules he drawn, we realise that post 2005 GSP, if on the one hand more required than ever, proved to be a much lesser efficient tool compared to pre 2003 situation on the other hand. The first lesson is about fiscal rules that are required only for countries with a bad reputation for fiscal discipline. If the euro zone members remain heterogeneous for that matter, Mediterranean members are immediately qualified to a need for further fiscal discipline (lesson n°2). And because of that, they need to meet the K-S criteria: that is lesson n°3.

The problem with euro zone fiscal integration is that it is impossible to set fiscal rules that would not be the same among its members. In other words, rules must be the same for all euro zone members even if some of them do not need fiscal rules as they follow sound and prudent discretionary fiscal policy. In such a situation, we must make sure that no fiscal free rider remains in the zone to maintain global reputation and low long-run interest rates.

The optimality of the Growth and Stability Pact remains however dependant on one extra factor that is not quantifiable: the degree of penchant of euro zone members for free rider behaviour, leaving us with two potential scenarios (Note 10).

- The discipline scenario: euro zone members do not take negative advantage of the higher flexibility of the GSP, perform structural reforms and respect their obligations in terms of decreasing fiscal deficits,
- The free-rider scenario: euro zone members do take negative advantages of the new GSP, do not perform structural reforms and maintain high fiscal deficits with increasing public debt and degrading public debt sustainability.

It is possible to formalise these two scenarios thanks to a temporal simulation (Table 2.). If the discipline scenario is of course highly desirable, the free-rider scenario would be extremely detrimental for both the member state and the whole euro zone. Considering this, the reformed GSP remains a potential source for both improvement and strong degradation of economic governance. Because of the fact that the distinction between the discipline scenario and the free-rider scenario lies in the good will of member states, it seems highly probable that at least one member state will always follow the wrong path, unless further reforms are performed.

To determine these reforms that are required to suppress the risk of a free-rider behaviour and increase the flexibility of the Growth and Stability Pact, it is necessary to identify the most problematic issues of the 2005 Growth and Stability Pact.

- The excessive public debt level does not generate any procedure nor penalties, meaning a lack of executive power, suitability and efficiency,
- National fiscal policies are not coordinated, avoiding a sound policy-mix to be set at the euro zone level, meaning a lack of consistency,
- Pro-cyclical national fiscal policies under positive conjuncture go against a good function of automatic stabilisers, meaning a lack of consistency.

The choice has been made in 2005 between flexibility and strong executive power/coercive capacities, with advantage to flexibility. The question is actually whether the increase of flexibility has compensated de degradation of executive power. This empirical study seems to show that it has not been the case and the 2008 financial crisis tends to exacerbate this trade-off. Still, Part 5 addresses the question of such a trade-off, showing that a choice might not be required between flexibility and discipline.

But the major problem is that coordination of national fiscal policies in the euro zone seems unlikely to happen unless a renewed process of further economic and political integration is initiated: to reach such a situation, European governments need to be more pragmatic in economic terms and should not maintain their position and search for flexibility and the expense of efficiency if they wish to enjoy a sustainable economic growth on the long run.

5. A renewed required fiscal governance

The potential perspective of a new modification of the Growth and Stability Pact needs guidance to address the most important limits of its current form. If we have identified these limits thanks to the KOPITS-SYMANSKI model, the impact of the 2008 financial crisis must be considered in all its forms to make final conclusions on how fiscal governance should be performed with more precise objectives and stronger tools to reach them. The increasing pressure over public debt and fiscal deficits of several euro zone members since 2008 and global fiscal structural deficits tend to be some of these important considerations to be taken into account before making a proposal for a better fiscal rule model for the euro zone.

5.1 Euro zone fiscal perspectives after the 2008 financial crisis

The 2008 financial crisis has been the deepest crisis since the great recession and is therefore an exceptional context to consider as, somehow, a stress test for the euro zone. The recovery that seems to have begun in the last quarter of 2009 tends to show the hysteresis of fiscal policies with the advantage of identifying the free-riders of the euro zone.

Figure 3. shows that the average public debt of the euro zone will continue to increase despite of the economic recovery. A more problematic issue is the structural fiscal deficit that increases since 2007, showing an even further need for fiscal discipline once the negative impacts of the financial crisis will have disappeared: the need for further

structural reforms will be higher after the financial crisis than it was before, leading to an extra need of flexibility for the next form of the Growth and Stability Pact.

The situation of some euro zone members and their difficulties in raising government bonds from the market at a low interest rate allows identifying the free-riders of the euro zone, showing that there is indeed such a behaviour in the zone, leading to the confirmation that more fiscal discipline is also required.

For instance, with a 1,2% of GDP recession in 2009 and low government credibility to damp down budget deficit (12,7% of GDP in 2009), Greece sees prices on its credit-default-swaps hitting all time high in January 20th 2010 when it had to pay an almost similar interest rate over its government bonds than Vietnam during the same period. Moving together with long-run interest rates, it seems the most problematic euro-zone member in terms of debt sustainability even if others have been identified by the market under the name of PIGS: Portugal, Ireland, Greece and Spain.(Note 11)

After having being under pressure on the financial markets in 2009, Ireland seems now to be in the right path to secure better fiscal governance, which is not the case of the other PIGS among which Greece and Portugal. These countries are the proof that some euro zone members do not see the justification for sharp structural reforms, enjoying the benefits of fiscal discipline in the zone without respecting it. Still, other countries such as the USA and Japan (Figure 4) are in much worse fiscal situations, leading to the assumption that financial markets do not speculate on countries that are supposed to be *to big to fail* but tend to make pressure over weaker fiscal credibility countries.

5.2 Coercion and flexibility: a more efficient GSP

If the European Central Bank can set a monetary policy that evolves depending on inflation tensions and economic conjuncture, and therefore follows a discretionary policy with respect to the monetary rules it has been designed on(Note 12), the Growth and Stability Pact lacks such a system that allows to evolve depending on external pressures, leaving euro zone members to determine on their own independent and uncoordinated fiscal policies, leading to fiscal uncontrolled slippages damaging both individuals and the whole zone.

As a consequence, to unite both flexibility and discipline, a renewed Growth and Stability Pact should evolve under three distinct forms depending on the different phases of the business cycle.

- Downward phase of the cycle: because of the fact that recessions require expansionist fiscal policies to be countered, the limit of fiscal deficit should be widened. As member states would go further anyway and be in excessive fiscal deficits, a more credible fiscal rule would gain in being lightened as then respected. Therefore, the new floor for fiscal deficit should be set at 4% of GDP instead of 3% of GDP under negative circumstances,
- Neutral phase of the cycle: A new floor would be specified under neutral conjuncture: the new floor would here be set at a 1,5% of GDP fiscal deficit,
- Positive phase of the cycle: favourable conjuncture should be used to improve structural fiscal balance and decrease public debt. Here a positive fiscal balance would be required to at least 1% of GDP. This extremely restrictive target would force euro zone members to perform sound economic reforms to neutralise almost completely structural fiscal deficits, leading to, during the overall cycle, a decreasing public debt.

This system would address the obligation to take into account the business cycle by the Growth and Stability Pact, allowing a sound flexibility and an easier task for the monetary policy as the policy-mix would improve thanks to a more reliable global fiscal policy that could also be anticipated by the European Central Bank (Note 13).

But to be efficient, it would also need to be backed by a system where no exceptional circumstances would be considered and where, whatever the situation, reforms would need to be implemented in the three months that follow European Commission's, not Ecofin Council's, recommendations. And unless full respect of the recommendations is initiated, member states would face immediate and heavy penalties without any probationary deposit period. Under such a system, discipline would be heavy and the system credible thanks to strong coercive capacities.

This policy rule model would however only be sustainable and efficient if the European Commission, not the Ecofin, would be given extra powers to implement and get respected these rules. Another question to be set would be to determine what European institution would be given the authority to specify in what phase of the business cycle the whole euro zone evolves. Yet again, the European Commission seems to be the only institution with the required authority and credibility to do so.

The new model would have a precise definition, would be transparent as rules would the same for all member states, highly suitable as it would perfectly match what the euro zone needs, extremely flexible as it would evolve with the business cycle, consistent as it would facilitate monetary policy, efficient as it would give space to discretionary policy when needed, and have a strong executive power thanks to extended coercive capacities.

The problem is that the model would not be simple as based on complicated processes to determine the phase of the business cycle; but as KOPITS and SYMANSKI (1998) raised the issue about their model, no fiscal rules can combine all the elements and simplicity might be the factor to be sacrificed to the cause of efficiency and sustainable long run economic growth. But the main issue to reach such a fiscal rule model remains the political will to renounce to a further fraction of national sovereignty over fiscal policy.

6. Conclusion

The belief that there is a trade-off in fiscal governance between flexibility and discipline proves to be incorrect. Fiscal rules models can gather these objectives but the capacity in preventing members from free-rider behaviour remains difficult to implement without damaging flexibility. If the 2008 financial crisis allowed to clearly identify the euro zone fiscal free riders, it also had a salutary impact on the obvious identification of fiscal and debt issues in the zone. Let's assume that this experience will push euro zone members to a better fiscal discipline and a lower penchant to avoid fiscal rules.

The 2008 financial crisis has had a long run impact on public finance too: the expansionary Keynesian fiscal policies generated an increase of structural budget deficit, leading to worse fiscal prospects for all developed economies and for some euro zone members in particular. With so high national debt levels, the next crisis might prove to be lethal for European economic integration as European economies might not have the fiscal capacities to perform counter-cyclical policies in the near future.

Therefore the question is not whether the euro zone needs fiscal policy rule; it does; the question being much more about political will to support a further loss of national sovereignty over fiscal policy to perform at the supranational level what has been impossible to do at the domestic level.

The euro zone needs centralised fiscal policy rule to back centralised monetary policy. This obvious remark for a sounder European policy-mix remains at this time a positive, not normative statement. The 2005 GSP reform did not help reaching that goal; it actually prevented it.

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Notes

Note 1. With increasing structural budget deficits, some EU members saw their fiscal deficits increasing with the automatic stabilisers, leading to strong fiscal deficits even before launching recovery plans through fiscal 'Keynesian' stimulus.

Note 2. European Council Resolution June 17th 1997 relative to Growth and Stability Pact, (EC) Regulation n°1467/97 aiming at accelerate and clarify the implementation of the procedure for excessive fiscal deficit, (EC) Regulation n°1466/97 relative to reinforcement of fiscal balances supervision.

Note 3.The participation to ERM2 is one of the Maastricht criteria to have access to euro zone membership. Some members use it, as Denmark, not to prepare euro zone adhesion but to follow a fixed exchange rate policy.

Note 4. (EC) Article 116.4.

Note 5. It would imply in 2010 that over 16 member states, 12 would not respect the criteria, leaving Luxembourg, Finland and Slovenia alone respecting the GSP.

Note 6.The model being sustainable as long as fiscal expansions remain lower to GDP than fiscal consolidations. This issue is discussed in Part 5.

Note 7. An excellent synthesis on that topic has been made by LEY (2004).

Note 8.Including procedures that prevent creative accounting practices, which is an issue in the euro zone with Greek (2003), Italian (2005), Portuguese (2001) and Greece again (2009) experiences.

Note 9. This model can be completed by the conditions raised by INMAN (1996) or partly replaced by a quite similar model BUTI, EIJFFINGER and FRANCO (2003) developed.

Note 10.These scenarios have been partly identified by the ECB (2006) but without the free-rider issue.

Note 11. Some other European union members suffer even higher long-term interest rates, such as Hungary and Latvia for instance, which postpones even more their euro zone participation.

Note 12. Inflation targeting where inflation is under but close to 2%. The first pillar of the ECB policy has been suppressed in 2002: the limitation of growth of money supply to a yearly 4,5%. It is a practical example of a flexible system managed by monetary rules.

Note 13.Yet the only European institution that has extensive experience in determining the euro zone business cycle is actually the European Central Bank. Taking it into consideration for whole European economic governance would therefore be relevant and would allow a perfect match between monetary and national fiscal policies.

Note 14. Because of incomparable data for 2009 and 2010, the number of euro zone member states that have a higher public debt than the 60% of GDP criteria is here a gross assessment based on fiscal balance estimates and previsions. We assume here that the Netherlands will have a public debt of 62% of GDP in 2009. We also assume here that Ireland will have a public debt of 64% of GDP in 2010.

Table 1. Application of the KOPITS-SYMANSKI model

'+' meaning condition fulfiled, '=' neutral condition,

'-' condition not fulfiled '- -' problematic condition

	GSP pre 2003	GSP pre 2005	GSP post 2005
Precise definition	=	=	-
Transparency	-	=	-
Suitability	=	=/+	=
Simplicity	=	=	-
Flexibility	+/=	=/-	+
Consistency	=/+	=/+	=/-
Strong executive power	-	=	--
Efficiency	-	-	+
Assessment compared to the initial Dublin form	**-2**	**0**	**-2,5**

Table 2. Procedure simulation for both scenarios

Source European Central Bank (2006) and author

Year	**Discipline Scenario**
T	A fiscal deficit higher than 3% of GDP is identified.
T+1	The Council decides that there is a situation of excessive fiscal deficit and issues a recommendation to absorb it.
T+2	The member state in infraction follows the recommendations and the excessive fiscal deficit is corrected.
T+3…	The yearly minimum 0,5% of GDP is followed until deficit is lower than 3% of GDP.
Year	**Free-rider scenario**
T	A fiscal deficit higher than 3% of GDP is identified.
T+1	The Council decides that there is a situation of excessive fiscal deficit and issues a recommendation to absorb it; still, the deficit continues to increase.
T+2	The Council decides that the deficit is significant and launches the procedure for excessive fiscal deficit. As a yearly adjustment of 0,5% of GDP would not be enough to absorb the deficit, the Council considers that there are exceptional circumstances and asks the situation to be solved in T+4 instead of T+3.
T+3–T+4	The procedure is not launched as it is dependent on the respect of the correction programme.
T+5	The Council notices that the fiscal deficit remains above 3% of GDP in T+4 but concludes that effective actions have been performed but that new exceptional circumstances did not allow the member state to respect the criteria. Therefore, it decides to renew its recommendations for T+5.
T+6	The Council realises that the deficit has not been contracted under 3% of GDP and issues new recommendations to correct the situation in T+6 but no improvement is realised.
T+7	The Council considers that new exceptional circumstances handicaped the capacity in respecting the obligations and renew its recommendations with T+7 as deadline.
T+8	The Council realises that the fiscal deficit has been contracted under 3% of GDP and the procedure for excessive budget deficit is abandoned.
T+9…	A new fiscal deficit is observed over 3% of GDP and the T to T+8 is renewed.

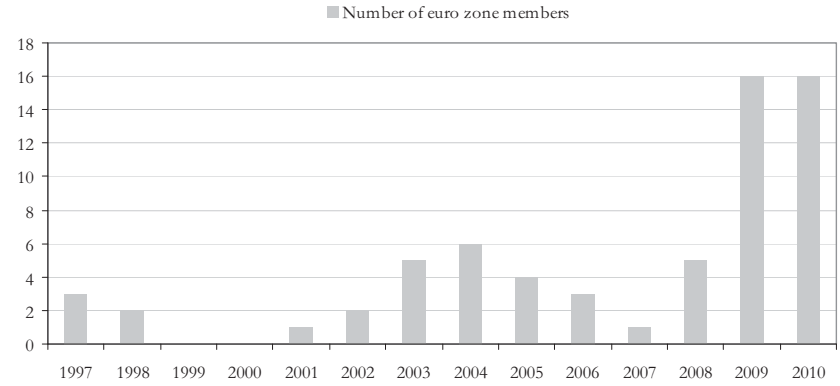
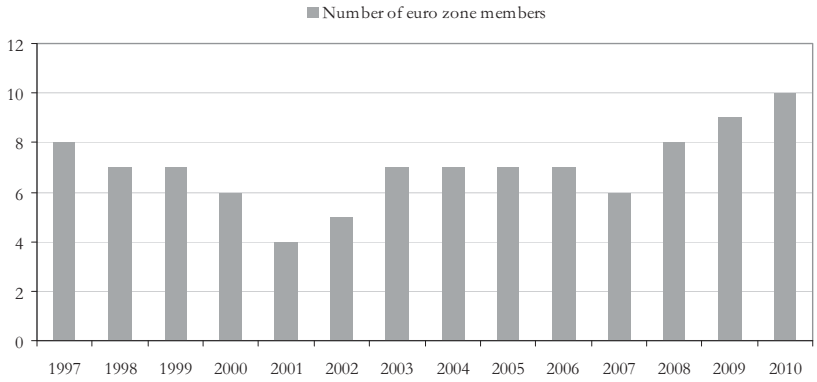


Figure 1. Number of euro zone members with excessive fiscal deficit (GSP criteria) 1997-2010

Source : Eurostat, OECD and IMF

2009: estimate; 2010: prevision



Note: Because of incomparable data for 2009 and 2010, the number of euro zone member states that have a higher public debt than the 60% of GDP criteria is here a gross assessment based on fiscal balance estimates and previsions. We assume here that the Netherlands will have a public debt of 62% of GDP in 2009. We also assume here that Ireland will have a public debt of 64% of GDP in 2010.

Figure 2. Number of euro zone members with over public debt criteria 1997-2010 (Note 14)

Source: Eurostat, OECD and IMF

2009: estimate; 2010: prevision

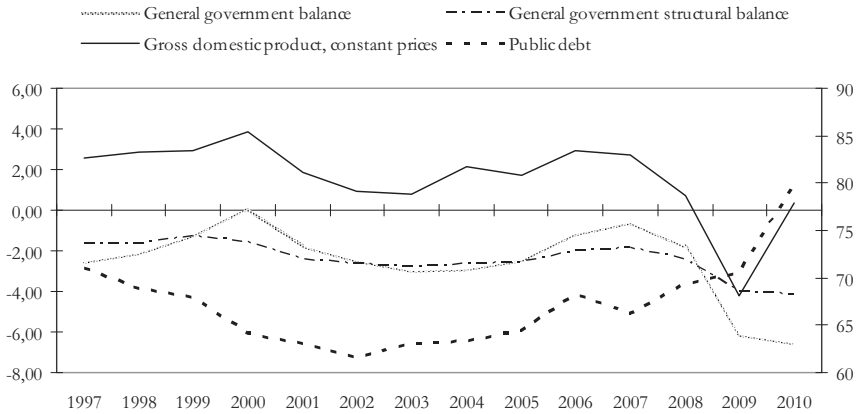


Figure 3. Euro zone GDP growth, average government balance and debt 1997-2010

Source: OECD and IMF

General government balance in % of GDP; general structural balance in % of potential GDP;

GDP growth in constant prices, Public debt in % of GDP – right axis