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Fabrizio Coricelli

**Design and Implementation of the Stability and Growth
Pact: The Perspective of New Member States**

Warsaw, June 2005

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Abstract

Current developments in the design and management of fiscal rules in the European Union may have negative implications for New Member States. Loosening of the Stability and Growth Pact (SGP) and a growing degree of arbitrariness in its implementation reduce incentives for fiscal adjustment in New Member States, adjustment that would be crucial during the transition to the Eurozone. High budget deficits may prove a serious obstacle in the process of catching up of New Member States to the income levels of EU-15 countries.

I. Introduction¹

Following entry in the European Union in May 2004, the larger New Member States (Czech Republic, Poland, Hungary and Slovakia) have been subjected to the Excessive Deficit procedure, according to the rules of the Stability and Growth Pact (see Box I). Hungary has even been declared in a state of excessive deficit. This pattern contrasts with past experience in the European Union. Entry in the European Monetary Union has been in the past a powerful mechanism to induce fiscal adjustment in EU members, such as Italy for instance. In the last few years, however, the Stability and Growth Pact has ceased to be an effective constraint on fiscal policy in EU countries. The decision of the ECOFIN (European Council of Economic Ministers) to stop the excessive deficit procedure for France and Germany weakened the credibility of fiscal rules in the EU. The reform of the Pact approved in March 2005 introduced a few innovations with respect to the old Pact, by allowing countries to breach under several circumstances the 3% ceiling, which is the maximum budget deficit as a ratio of GDP admissible for EU members. First, countries will be excused not only when there are exceptional circumstances, such as a decline in output higher than 2%, but also when there is a persistent slowdown of the economy, or when countries undertake reforms, for instance pension reform, that have an adverse impact on the budget. Furthermore, the horizon for adjustment has been lengthened. It is hardly disputable that the inability to effectively pressure large EU countries to adjust their budgets and the reform of the SGP have sharply increased the degree of arbitrariness in the evaluation of fiscal policy and in the implementation of the SGP.

Box I: The Stability and Growth Pact (*)

The Stability and Growth Pact (SGP) is the concrete EU answer to concerns on the continuation of budgetary discipline in Economic and Monetary Union (EMU). Adopted in 1997, the SGP strengthened the Treaty provisions on fiscal discipline in EMU foreseen by articles 99 and 104, and the full provisions took effect when the euro was launched on 1 January 1999. In March 2005 the Ecofin approved modification, especially in the implementation of the SGP.

The principal concern of the SGP was enforcing fiscal discipline as a permanent feature of EMU. Safeguarding sound government finances as a means to strengthening the conditions for price stability and for strong and sustainable growth conducive to employment creation. However, it was also recognised that the loss of the exchange rate instrument in EMU would imply a greater role for automatic fiscal stabilisers at national level to help economies adjust to asymmetric shocks, and would make it "necessary to ensure that national budgetary policies support stability oriented monetary policies". This is the rationale behind the core commitment of the SGP, i.e. to set the "... medium-term objective of budgetary positions close to balance or in surplus..." which "... will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3% of GDP".

Formally, the SGP consists of three elements as follows:

- *a political commitment* by all parties involved in the SGP (Commission, Member States, Council) to the full and timely implementation of the budget surveillance process. These are contained in a Resolution agreed by the Amsterdam European Council of 17 June 1997. This political commitment ensures that effective peer pressure is exerted on a Member State failing to live up to its commitments.
- *preventive elements* which through regular surveillance aim at preventing budget deficits going above the 3% reference value. To this end, Council Regulation 1466/97 reinforces the multilateral surveillance of budget positions and the co-ordination of economic policies. It foresees the submission by all Member States of stability and convergence programmes, which are examined by the Council. The Regulation foresees also the possibility to trigger the early warning mechanism in the event a significance slippage in the budgetary position of a Member State is identified.
- *dissuasive elements* which in the event of the 3% reference value being breached, require Member States to take immediate corrective action and, if necessary, allow for the imposition of sanctions. These elements are contained in Council Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

Besides these legal basis, the Code of Conduct on the content and format of the stability and convergence programmes, endorsed by the ECOFIN Council on 10 July 2001, incorporates the essential elements of Council Regulation 1466/97 into guidelines to assist the Member States in drawing up their programmes. It also aims at facilitating the examination of the programmes by the Commission, the Economic and Financial Committee and the Council.

(*) Source: European Commission website.

¹ The author wish to thank, without implicating, Anders Aslund, Jean Pisani-Ferry and Vito Tanzi for very useful comments on an earlier draft of this chapter.

In such a context, rather than clear reference points and clear constraints, access to the Eurozone and the SGP become for NMs moving or elusive targets and “flexible” constraints.

In this paper we argue that an effective implementation of the SGP is crucial for NMs, perhaps even more than for “old” EU members. Indeed, NMs are still emerging markets, characterized by dependence on foreign finance, large current account deficit, weak financial markets, higher potential output growth, but also higher volatility of main macroeconomic variables.

Interestingly, one of the official justifications for the reform of the SGP has been enlargement of the EU: “The Stability and Growth Pact needs to be strengthened and its implementation to be clarified, with the aim of improving the coordination and monitoring of economic policies. In doing so, due account should be taken of changing circumstances, in particular the increased economic heterogeneity in the Community of 25 Members and the prospects of demographic changes” (European Commission, Proposal for a Council Regulation, Brussels 20.4.2005). Although some new features of the SGP, such as consideration of different growth of potential output, different initial conditions in debt levels and the fiscal impact of growth-enhancing reforms, represent improvements, one cannot neglect the risks that a less clear set of rules may produce an increased arbitrariness in the implementation of the SGP. This is the most worrying aspect of recent developments. We also emphasize that giving more relevance to debt sustainability rather than budget deficits, while generally correct, risks to give the wrong incentives to NMs, most of them characterized by low levels of debt. The peculiar features of NMs, such as the low development of financial sectors and high volatility output and fiscal revenues, call for a careful definition of safe debt-to-GDP ratios. We argue that there is little room for increasing debt ratios in NMs and we suggest to complement the SGP framework with national expenditure rules. These rules should also serve as a more effective reference for evaluating policies, avoiding confusion between policies and noisy outcomes.

The paper is structured as follows. In section 2 we argue that during the transition to the Euro, especially during the ERMII period NMs have to rely on tight fiscal policies in order to avoid sizable output costs and the risk of failing the transition to the Euro. In section 3 we discuss the main trends of fiscal policy in NMs, highlighting the presence of two distinct patterns, one of low deficits in small countries and the other of high deficits in larger countries. In section 4 we discuss some features of the SGP, and its revisions, from the perspective of NMs. Section 5 contains some concluding remarks.

2. Fiscal policy and the pace of transition to the Euro

The target of entry in the European Monetary Union has been effective in fostering fiscal adjustment in several EU countries during the 1990s (see Gali and Perotti (2004) among others). Similarly, the same effect could be at work for new EU members, that eventually have to join the Eurozone. However, one can identify two distinct patterns of behavior in new EU members. One group of countries, the smaller ones, have embarked in a process of prudent fiscal policy that is accompanying their fast entry into the Euro. Another group, formed by the larger countries, entered the EU with high and growing budget deficits. At the same time, they have opted for a much slower path towards the Euro. Of course, the two aspects are closely linked, as fulfilling the Maastricht criterion on the budget ceiling of 3% of GDP is a pre-requisite for joining the Eurozone. The procedures leading to accession to the EU did not involve any conditionality on macroeconomic indicators for Candidate countries. In several NMs there was a marked deterioration of the fiscal accounts during the run-up to entry in the EU. Apparently, NMs did not perceive they would be subject to tight fiscal constraints upon entry, although the ceiling of 3% on budget deficit and the Stability and Growth Pact apply to every member of the EU. There was a strange, perhaps accidental, convergence between the positions of “populist” forces within the new members pushing for higher deficits and EU institutions, EU Commission and ECB, that explicitly favored a slow process of entry in the Eurozone. In a nutshell, the idea was that there was a trade-off between “real” and

“nominal” convergence and not a complementarity between the two. Budget deficits could be tolerated as they were considered instruments for stimulating growth.

3. Fiscal policy in NMs: an heterogeneous picture

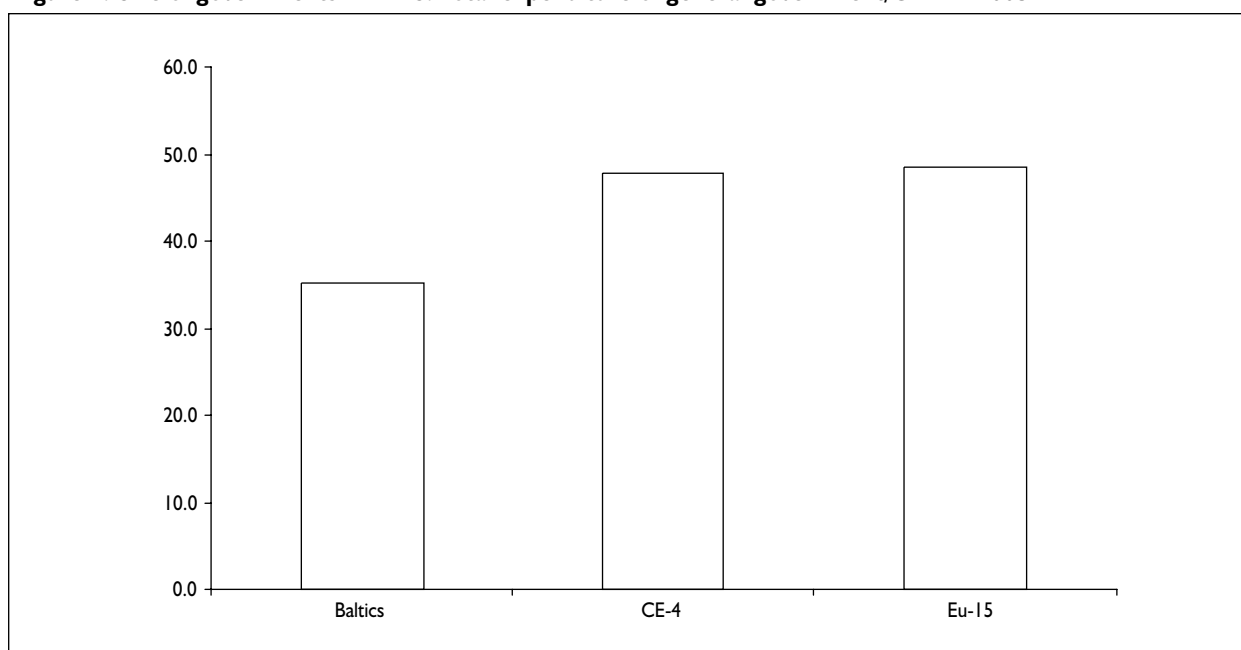
The first feature of public finances in NMs is that the “size of government” (revenue, or expenditure-to-GP ratios) in these countries seems to be high for their level of development, proxied by incomes per capita.

3.1. Size of the government

Figure 1 shows that the size of government in NMs is not far from the EU average, in spite of the fact that the average GDP per capita in NMs is below 50% of the EU average. This is true for Central European countries, while the Baltics are characterized by a much smaller size of government. One could thus conclude that the size of the government is too large for the level of development of NMs. In other words, one could argue that NMs have adopted prematurely the “European model”. It should be noted, however, that GDP per capita is only one of the variables affecting the “natural” size of the government. The demographic structure is certainly another factor, and in this respect NMs have a population structure and population growth similar to old EU members. Another factor recently emphasized by Rodrik (1998), is the degree of openness to foreign trade of an economy. According to Rodrik, trade openness increases the risk of output fluctuations of an economy, resulting from fluctuations in terms of trade. Indeed, the income effect of terms of trade changes is given by the variation in terms of trade multiplied by the share of trade-to-GDP. If the latter increases, the income effect of terms of trade fluctuations increases as well. An increase in the size of the government would compensate such effects, stabilizing output changes.

Although this view might have some relevance for the evaluation of the size of governments in NMs, it should be taken into account that for NMs increase in openness goes hand-in-hand with integration in the EU, which implies an integration both in trade flows but also in terms of factor movements and financial sectors. Free capital

Figure 1. Size of governments in NMS. Total expenditure of general government/GDP in 2003



Source: Eurostat

mobility induces pressure for reductions in the size of governments through tax competition. Moreover, capital mobility and financial integration allows more diversification of risk in all EU member states. As a result, the Rodrik channel is less relevant as the financial sector permits to insure against risk of income fluctuations.

Finally, the large size of governments of NMs results from an explicit strategy followed during their transition process. Such strategy was largely affected by the so-called “attraction of Europe” (Boeri 2000). In contrast with the strategy followed in most countries of the former Soviet Union, NMs implemented far-reaching market oriented reforms and the same time maintained a system of safety nets, in some cases extremely generous. Such strategy was perhaps one of the key elements for the success of the transition in NMs. Looking forward, however, the issue is whether maintaining such a large government may interfere with the growth process of NMs.

Most NMs have indeed problems similar to old EU members. High tax burden on labor have likely affected incentive to work and thus labor supply. Employment rates are low in NMs, unemployment rates are generally high and the underground economy is estimated to be very large².

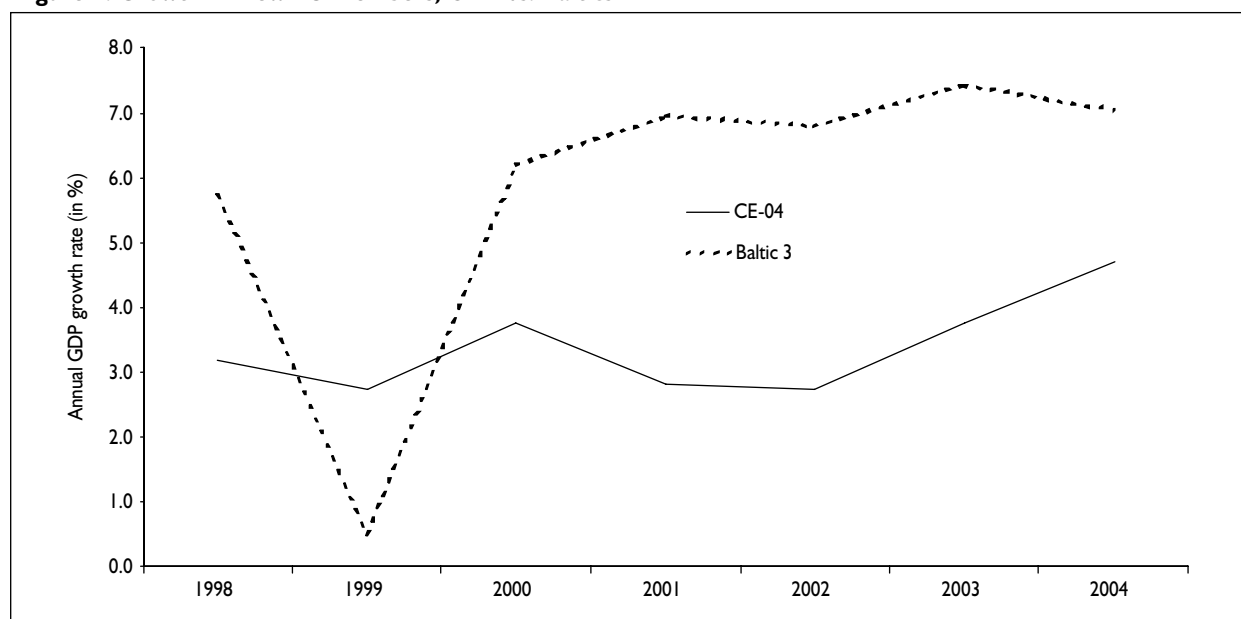
The experience of NMs has been highly heterogeneous: one can identify two distinct groups of countries that are following different fiscal strategies with sharp differences in the behavior of budget deficits and debts.

3.2. Deficits

Budget deficits have been on average well above 3% of GDP, except for Slovenia and the Baltics. Interestingly, it appears that country size matters for fiscal policy. However, low-deficit countries, especially the Baltics, are also the countries with a currency board, or a fixed exchange rate regime.

The comparison between the Baltics and Slovenia on one side, and the other NMs on the other side suggests that high budget deficits cannot be attributed to special factors associated with transition and EU accession. Without denying that these factors have exerted some pressure on budget deficits, it is nevertheless clear that they cannot account for such a sharp different pattern of behavior within countries characterized by the same transition and EU-accession process. The difference in size of the countries perhaps suggests the importance of

Figure 2: Growth in New EU members, CE-4 vs. Baltics



Source: Eurostat

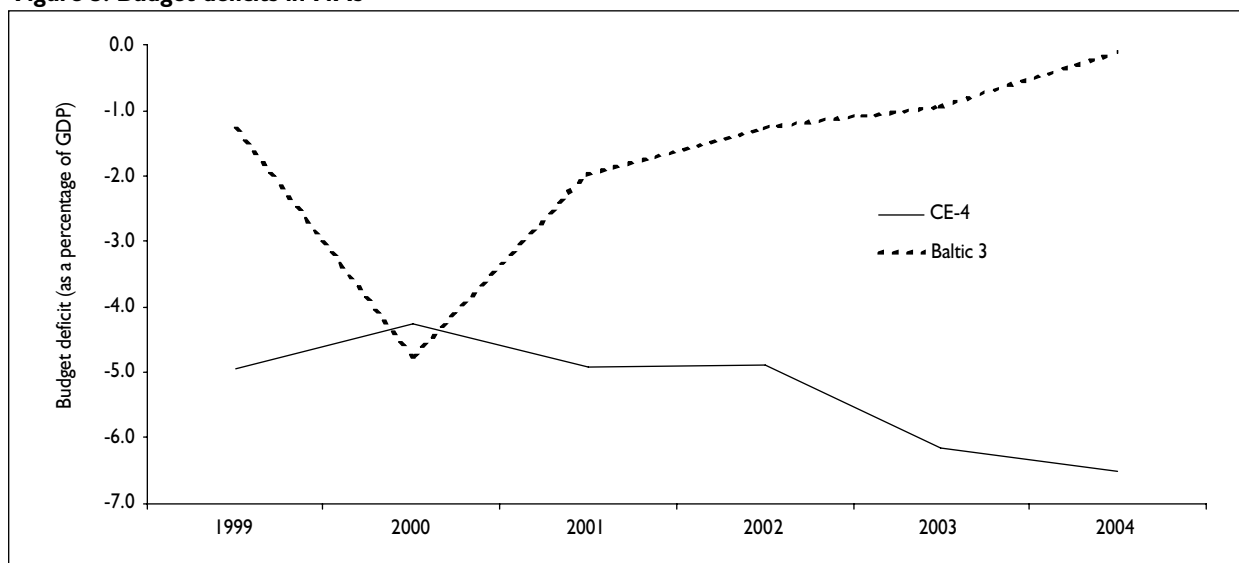
² For these reasons, several NMs have opted for a policy of low income and corporate taxes. This strategy has brought Estonia, Lithuania and Slovakia to adopt a flat tax system, that is currently under attack from several government officials in old EU members.

political economy factors. In small and more homogeneous countries there is less scope for using the budgetary process to buy consensus for election and re-election. However, it is not easy to distinguish such political factors from economic factors, such as the stronger constraints for small and highly open economies.

Nevertheless, it is interesting to contrast also the much better growth performance of the Baltic countries with that of the CE-4 countries (Czech Republic, Hungary, Poland and Slovakia) (Figure 2), which suggests that prudent fiscal policy and growth were complements in the Baltic states.

In addition, there is no clear correlation between size of budget deficits and public investments, contrary to what it is often heard as justification of high deficits in NMs (Figure 3).

Figure 3. Budget deficits in NMs



Source: Eurostat

Thus, it can be argued that large NMs perceived they had no binding constraint in their fiscal accounts during the process of entry in the EU.

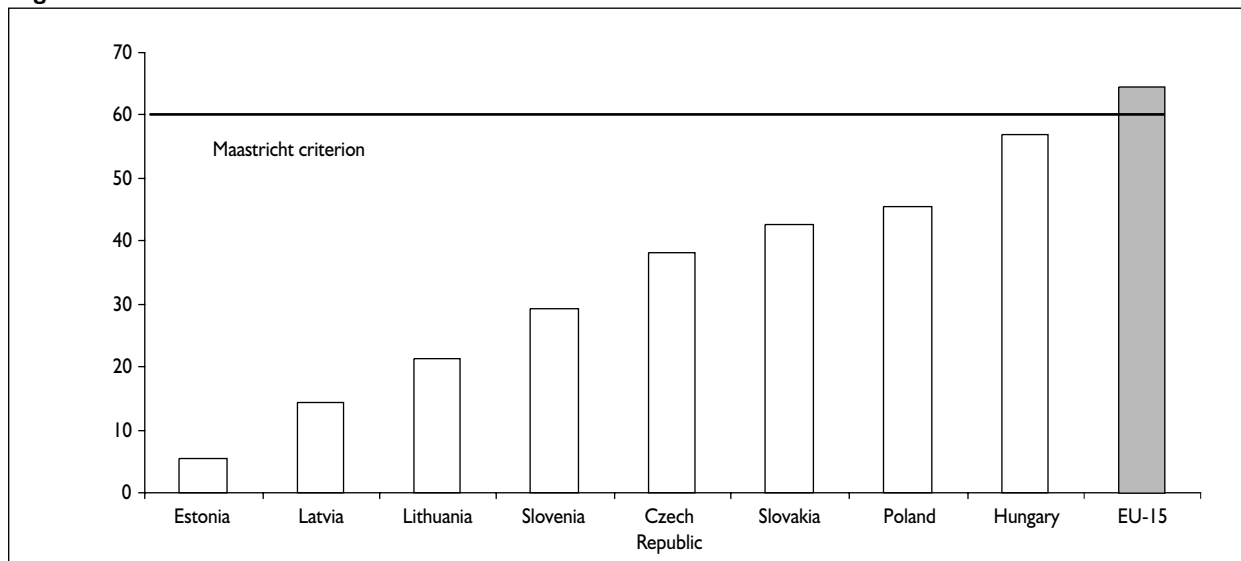
3.3. Debts

On average NMs display debt-to-GDP ratios well below those of old EU members. However, EU countries may not be a good comparator for judging debt ratios of NMs, that are emerging markets rather than established advanced economies.

Financial sectors are still underdeveloped in CEECs and their public debts have a large component of foreign debt. If compared with Latin America, for instance, debt ratios of NMs, are of the same order of magnitude. Even after entry in the EU, as long as they remain outside the Euro-zone, NMs debt should be considered as emerging market debt, subject to the same volatility and risks of other emerging economies. Indeed, in the recent revisions of the SGP, countries with debt-to-GDP ratios below 60 percent should have more room for expansionary fiscal policy. While one could support such proposal when applied to current EU members, its rationale for new members is highly questionable.

The stock of public debt in NMs should be evaluated from two perspectives, different from the simple debt-to-GDP ratio and from long-term solvency issues. The first is the size of public debt relative to the size of domestic financial markets. Indeed, in countries with still underdeveloped financial sectors, the crowding out effect of public debt can be very serious. Figure 5 displays debt-to-M2 ratios for NMs and compares them with

Figure 4. Debt-to-GDP ratios in 2003

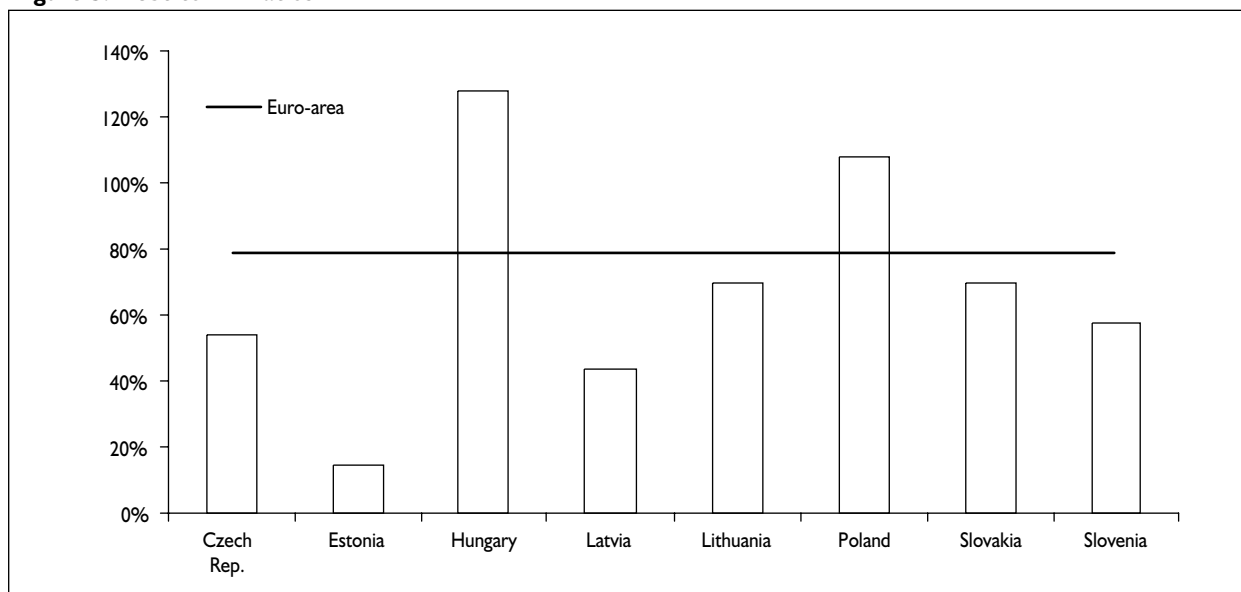


Source: Eurostat

old EU countries. The striking result is that this measure gives a picture in which debt ratios in NMs are much closer to those of old EU member states and in some cases even higher.

The second relevant perspective for countries that are still emerging economies is related to the notion of “natural debt limit” recently proposed by Mendoza and Oviedo (2004), that takes into account the uncertainty associated to high volatility of revenues, combined with rigidity in expenditure, for countries that might face severe constraints on availability of foreign borrowing. Emerging economies do not have the same ability to use international financial markets to smooth the effects of large shocks. In cases of severe difficulties emerging economies find it very hard to borrow abroad at reasonable rates. This phenomenon has been defined as one of “sudden stop” in the recent literature (see Calvo et al (2003)). Such sudden stop can be seen as a “worst case” scenario for a country. In such an event, the country has to adjust its imbalances, including budget deficits. Given that emerging markets have accumulated public debts, largely owed to foreigners, the question is whether in the event of a sudden stop these countries are able to service their debt, taking into account their ability to raise revenues and compress expenditure.

Figure 5. Debt-to-M2 ratios



Source: Eurostat and EBRD

This perspective gives a much more relevant evaluation of debt sustainability than measures of long run solvency.

The key elements that make this approach relevant are the fact that emerging economies display a much higher volatility of fiscal revenues than advanced market economies. This means that in an adverse situation revenue-to-GDP ratio may decline sharply in emerging economies. At the same time public expenditure cannot be compressed to zero, as there are items that are rigid. Of course, the notion of rigidity of expenditures depend on the structure of expenditure and the political process associated to it. Nevertheless, we can usefully identify the rigidity of expenditure looking at the minimum ratio observed in recent years for a country or, as for revenues at the difference between the mean and the standard deviation of revenue-to-GDP realizations.

Figure 6 indicates that NMs, like other emerging economies, display a much higher volatility of revenue-to-GDP ratios. We select the case of Estonia to compute the “natural debt limit”. The reason is that Estonia is the country with the lowest debt-to-GDP ratio and with fast real GDP growth. In such a case, computation of debt solvency will indicate a very high equilibrium debt-to-GDP ratio. As a result, one would be tempted to advise Estonia to rapidly increase its public debt, to exploit the room between its current levels and the 60% compatible with fulfilling the Maastricht criterion on debt. In fact, computing the natural debt limit for Estonia is instructive as it shows that current levels are not very far from the levels consistent with such “natural limit”.

The definition of NDL is $NDL = \frac{T_m - G_m}{R - \gamma}$, with

T_m = “worst case” realization of revenue-to-GDP ratio

G_m = minimum level of expenditure

R = real interest rate

γ = rate of growth of real GDP.

It is useful to compare such definition with the level consistent with long run solvency

$$D = \frac{T - G}{R - \gamma} ,$$

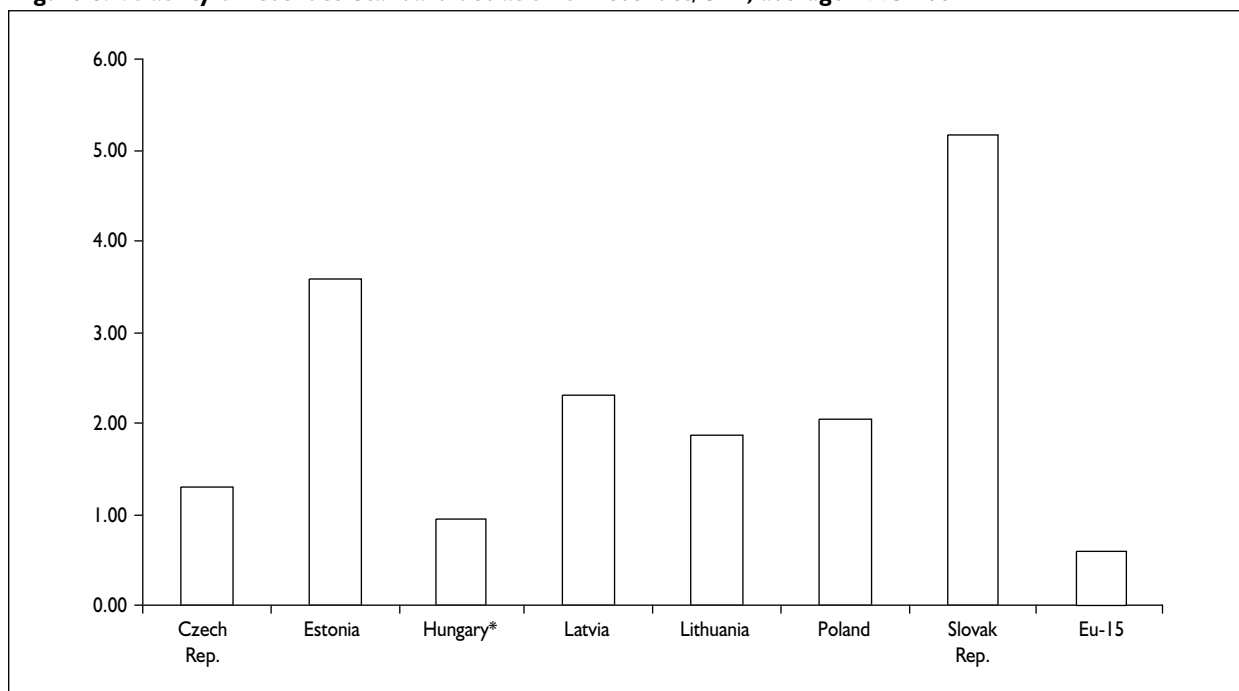
where the value of the numerator indicates the current level of primary surplus.

We compute the worst case level of revenue-to-GDP ratio for Estonia as the difference between the average ratio and twice its standard deviation. We use the same formula for minimum expenditure. We use a real interest rate differential with respect to real growth of 1.6. Interestingly, the NDL is equal to 20 percent of GDP. Of course, such calculation is only illustrative. However, it is useful to compare it with the traditional level computed looking at long run solvency. Using the same numbers for the real interest rate and the real rate of growth, such a level is 66% . The huge difference between the two measures of equilibrium debt levels indicates the important feature of revenue volatility typical of an emerging economy. This example suggests that for NMs one should use some sort of different scale of evaluation for the debt-to-GDOP ratio. An implication is that for NMs it is advisable to give large weight to deficit indicators, rather than the Maastricht debt ratio. Of course, this implies that NMs approaching 60% are *a fortiori* in a risky zone.

The emphasis on deficits rather than debts would seem highly questionable (see Buiter (2004)) for countries that are characterized by much higher rates of growth of output. As shown in next section, our approach and that of Buiter can be reconciled by taking seriously the close-to-balance budget over the cycle, that is the cornerstone of the Stability and Growth Pact. Our view might seem overly restrictive for NMs, but in fact it only

suggests that during the period of transition to the Euro, debt of NMs has a much higher risk than that of old EU members. Such risk is unlikely to be incorporated in risk premia by the market, as it is a risk associated with a low probability event (the worst case scenario).

Figure 6. Volatility of revenues Standard deviation of Revenues/GDP, average 1995-2004



* For Hungary data are for the period 2001-2004

Source: Author's calculation on data from Eurostat.

NMs should be advised to adopt medium term fiscal frameworks that imply close-to-balance budget over the cycle, and thus stable debt-to-GDP ratio over the same horizon. Unfortunately, the current approach to implementation of the SGP has several drawbacks, especially if viewed from the perspective of NMs.

4. Shortcomings of the existing framework for new members

The EU fiscal framework is based on three main assumptions.

(i) On the basis of the volatility of GDP for EU member states, it appears that 3% provides a sufficient margin to absorb “normal” cyclical fluctuations. During “exceptional times” the 3% ceiling can be breached without penalties. This implies that in “normal” times there is no pro-cyclical bias in the rule during “bad times”. It remains open the issue of the incentives to avoid pro-cyclicality during “good times”. The SGP is indeed a way to tackle this issue by indicating that countries should ensure convergence over the medium term to a balanced structural position. Accordingly, in periods of favorable cycles governments should run budget surpluses, matched by deficits during downturns. As, on average, the budget is balanced, the 3% ceiling will be passed only during exceptional times. This is connected to the idea of safety margins.

(ii) The EC estimates that in most EU countries the budget elasticity to the output gap is between 0.5 to 0.6. This means that one should observe a cyclical deficit of roughly half the output gap. In order to pass the 3 percent ceiling one should experience a negative output gap of roughly 6 percentage points of potential output, if the budget is initially balanced. This event is rather unusual. For instance, in France during the period 1980-2002 the largest negative output gap was 2.6 percent in 1985, while in Germany it never exceeded 1.6 percent.

(iii) The cyclically adjusted balance provides a good measure of the discretionary policy of national governments.

Summing up, a country that behaves well should have counter-cyclical deficits due to the functioning of automatic stabilizers. This functioning of automatic stabilizers is fully consistent with the 3 percent limit for well-behaved countries. We will in turn discuss the three elements of the EU fiscal framework and highlight their limitations. First, we show that the foundations for the 3% ceiling and the cyclical safety margin are rather weak, especially for NMs. Finally, we emphasize the drawbacks of the evaluation and monitoring procedures of the EC, that are not solved by looking at the cyclically adjusted budget.

4.1. GDP volatility and the 3% ceiling

The 3% deficit ceiling had been thought for countries with potential output growth of about 2%. With an elasticity of the budget balance to the output gap estimated by the EC at about 0.5, a country shifting from the potential growth path to a decline of 2% in GDP would suffer a worsening of the budget of 2% of GDP. Thus, if countries followed the objective of close-to-balance budget over the cycle, they would risk to hit the 3% ceiling only in exceptional cases. However, countries characterized by much higher rates of growth of potential output are also exposed to much wider band of oscillation of GDP. A negative GDP change of 2% from a potential growth path of 5% would imply a 7 percentage points change. With similar elasticity of the budget to GDP, which is indeed the case for NMs, that have revenue-to-GDP ratios of the same magnitude of EU-15 countries, NMs can easily hit the 3% ceiling even in a normal cycle³.

Incomes per capita in NMs are on average 40 percent of those of the average EU country. Convergence to EU levels of GDP per capita is going to be a long term phenomenon. Thus, for a few decades NMs should display higher rates of growth than those of EU countries. Assuming the Barro well-known rule of thumb on convergence, NMs should grow at a rate that is 2 percent higher than the average EU. Studies on the European Union and in general on monetary unions, suggest higher rates of convergence, close to 3 percent. As the average rate of growth of potential output is around 2 percent in the EU, potential output in acceding countries can be expected to grow between 4 and 5 percent per annum. The volatility of GDP growth is also likely to be much higher than that of EU countries. This implies that with neutral fiscal policy stance, fluctuations in cyclical budget balances should display a much larger amplitude, following the higher amplitude of fluctuations in output. This can indeed be observed in the data. Looking at the period 1996-mid 2002, a recent paper by the ECB finds that NMs posted an average rate of growth of GDP of about 4% against a 2.2% of Euro area countries. Volatility was much higher in NMs, with a standard deviation of output growth almost three times higher than that of the Euro area (Süppel (2003)). The study concludes that since higher growth and higher volatility of growth reflect a catching up process, they are going to persist in the medium run. Given these structural features, the 3% ceiling on the budget deficit does not represent a sufficient margin to absorb cyclical swings in budget deficits. For current EU members, with an estimated elasticity of the budget to the output gap of around 0.5, the 3% budget deficit limit represents a wide enough margin to absorb regular cyclical fluctuations in the budget. While this is disputable even for current EU members, it is hardly applicable to acceding countries.

4.2. Pro-cyclical bias

A second possible drawback of existing rules is the pro-cyclical bias, associated to the fact that the budget deficit deteriorates during recessions and if it approaches the 3% ceiling, governments have to undertake

³ As shown by the EC(2003), the GDP elasticity of the budget is dominated by the revenue effects. Coricelli and Ercolani (2004) find indeed output-gap budget elasticities for NMs only slightly lower, at around 0.45, than those of EU-15 countries.

adjustments during “bad times”. According to Gali and Perotti (2003), the Maastricht criterion on the budget deficit has not been a constraint on counter-cyclical policies by countries in EMU. This effect is derived through an estimate of the impact of the output gap on the behavior of the cyclically adjusted deficit, contrasting the pre with post-Maastricht phase. They find no effect of a pro-cyclical bias after the introduction of fiscal constraints. A recent report by CEPR (2004) broadly confirms this result. It finds that only in the case of Portugal and Italy there has been a tightening of fiscal policy during a downturn. However, it could be argued that a similar effect would have been detected for Germany and France, had the Excessive Deficit procedure been approved by the ECOFIN. This would have implied a pro-cyclical stance in four members of the EMU during the most important episode of downturn of the post-Maastricht period. Thus, although there is no strong evidence of pro-cyclical bias in the existing fiscal rules, it clearly emerges that a sizable slowdown in the rate of growth of output sharply increases the probability of hitting the 3% ceiling, a problem that is bound to be much more serious for NMs, as the magnitude of the changes in growth rates is likely to be much higher than that of current EU members.

Furthermore, looking at correlations between cyclical variations of government consumption and GDP, we found that NMs, as other emerging markets display a pro-cyclical fiscal policy (see Fiorito (1997) and Talvi and Vegh (2000) for a discussion of such methodology). Considering that government consumption does not vary automatically with the cycle, it can be used as a proxy for the discretionary component of fiscal policy. A positive correlation between the cyclical components of government consumption and of GDP is a measure of the pro-cyclicality of fiscal policy. Indeed, for several NMs such correlation was positive or close to zero during the period 1995-2003 (Table I, Coricelli and Eianchovina (2004)). This indicates that, so far, there has been little counter-cyclical role for fiscal policy in NMs. The fact that EU fiscal rules do not provide effective disincentives for pro-cyclical policies, either during good or bad times, might be a serious drawback for NMs that tend to have pro-cyclical fiscal policies.

Table I. Correlation between cyclical variations of government consumption and GDP, 1995-2003(*)

Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Slovakia	Slovenia
0.80	0.03	-0.06	0.30	0.63	0.84	0.34	-0.58

(*)Quarterly data. Cyclical variations are computed as percentage deviations from trend, computed with Hodrik-Prescott filter.
Source: Author's calculation on data from Eurostat.

4.3. Evaluating policies not only outcomes

Rules are important because they can strengthen the credibility of policies. The current crisis of the SGP illustrates however the distinction between the credibility of policies and that of policy-makers. There is indeed an inconsistency in the current framework. Besides the motivations for the specific numbers chosen, there has been several papers by the EC to provide economic foundations to the whole apparatus of the deficit/debt ceilings and the SGP. The cornerstones are:

The task of the EC is to monitor fiscal accounts and to evaluate the Stability and Convergence Programmes of national governments. When the structural (or cyclically adjusted) balance is seen increasing to an area that will put the country at risk of breaching the 3% ceiling, governments are invited to adopt an adjustment plan that would put the country in a safe area. On this basis national governments and EC discuss the budgetary plans. If the government follows those plans it should be defined as a “dependable” government, and thus a credible policy-maker. However, if a government behaves accordingly to the stated plans and ex post the EC identifies the government as behaving against the rules, there is an obvious problem. Of course, in the interpretation of the outcomes there is always scope for opportunistic behavior of policy-makers. Nevertheless, it is fair to admit that there are fundamental flaws in the rules. Unexpected outcomes, unrelated to policy actions cannot be used to evaluate policy-makers. The conceptual underpinning of the 3% ceiling is flawed.

Consider the following example. Country A in year t has a balanced budget. In the following three years it plans to increase expenditure in line with the expected rate of growth of output. Assuming no change in tax rates and in tax collection, and assuming that a unitary elasticity of revenue with respect to GDP, the budget is expected to remain balanced in the period of planning. Furthermore, the country was growing at 3 percent in the year $t-1$. GDP is expected to remain at 3 percent for the three years considered. In fact, the economy slows down and the rate of growth declines to 1% per annum. The output gap may remain positive (actual output greater than potential). Nevertheless, the deficit deteriorates, approaching the 3 percent ceiling. From an ex ante point of view the government has maintained its promises. The cause of the deficit is a forecast error. The increase in the budget deficit would be measured as totally due to an increase in the structural deficit. However, the government has not switched to a looser policy through discretionary measures. It is just the ex post evaluation of policy that depicts a behavior of the policy-maker that does not reflect the reality. The first conclusion to draw is that the current framework for evaluating fiscal policy in the EU is misleading. This interpretation has surfaced also in the revised SGP. A proper definition of discretionary policy should take into account the fact that the actual budgetary process is based on expected output (see also Buti and Van den Noord (2003) and Larch and Salto (2003)).

If governments were welfare maximizers, they would generally follow a fiscal rule consistent with tax smoothing. This amounts to set expenditure accordingly to the expected growth of potential output⁴. Abstracting from measurement errors of potential output, this rule would imply a structural balanced budget and cyclical budget balances proportional to the deviation of the rate of growth from potential growth. Actual developments of GDP will determine the movements in the budget balance and not the level of the output gap. Expenditure will be by construction counter-cyclical, with a unitary elasticity of expenditure-to-GDP ratio with respect to the deviation of growth from potential. Although this cyclical movements of expenditure is different from what are commonly defined as automatic stabilizers, in fact they work in a similar fashion as potentially stabilizing forces.

Of course, if there is a persistent over-estimation of potential growth, there will be a persistent deficit. For this reason, a confidence interval on the calculation of potential growth should be applied and the lower end of the expected band should be chosen, ensuring a prudent management of expenditure. This error is likely to be much smaller than the forecast error on actual GDP. Neutral fiscal policy can be defined as the one consistent with the above rule (see also Buti and Van den Noord (2003) and CEPR, MEI 13, 2004). The difference between actual and neutral policy can be defined as discretionary policy. Moreover, from this discretionary policy one should subtract the effect of forecast error of actual GDP to obtain what Buti and van den Noord define as “genuine” discretionary policy, as expenditure is planned ex ante on the basis of expected output.

Thus, even with the amendments introduced in the SGP, the current framework is affected by ambiguity of interpretation of fiscal stance, leaving room to political influence on such interpretations.

The Stability and Growth Pact and the numerical limit of 3% on the deficit are an example of how rules can be simple but at the same time highly ambiguous, especially within the new SGP. The 3% limit is very simple and within the SGP the procedures that the EC has to follow are roughly automatic. However, the fact that ECOFIN has the final word on whether the ED procedure should be adopted, combined with controversial measures, such as the cyclically adjusted balance, used to evaluate fiscal stance, reduce the credibility of EU fiscal rules and make its implementation subject to decisive political interference.

The first conclusion is that the existing indicators used by the EC to evaluate the fiscal policy of EU governments are misleading⁵. However, forecasts are likely to be biased, reflecting an opportunistic behavior by governments that for political reasons tend to overestimate growth (Larch and Salto (2003)). Interestingly, in the

⁴ See Coricelli and Ercolani (2004) on this type of rule.

⁵ This is recognized in the two papers by economists at the EC indicated above (Buti and Van den Noord (2003), Larch and Salto (2003)).

main episode of crisis of the SGP, associated to the early warning to Germany and France, the forecast error was as large in the EC data as in the national data. Without denying the relevance of political or political economy considerations, it clearly emerges that the current framework of evaluation of fiscal policy in the EU leaves ample room for arbitrary interpretations and endless debate between national authorities and the EC. To summarize, the simplicity of the existing rule is only apparent. The whole mechanism is extremely complex and ambiguous in its implementation. The result is a loss of credibility for the entire fiscal framework in the EU. On one side, the behavior of ECOFIN damages the credibility of the EC; on the other side, the application of the procedure of the SGP damages the credibility of national fiscal authorities, providing an improper assessment of their discretionary policy.

Therefore, there is a need to move to a monitoring of policies and not exclusively the results (a point also stressed by Annett et al. (2005)). It is well known that one can reduce the problem of time inconsistency in policies acting on the predictable part of policy, not on unforeseen events (Drazen (2004)). All these issues are more relevant in an enlarged EU as forecast errors for NMs are bound to be larger given the higher standard deviation of GDP growth in the new member countries.

The debate on the reform of the SGP that is taking place is unlikely to produce a fundamental reform of EU fiscal rules. In the summer of 2003 the EC has put forward a proposal for some modifications of the SGP. The modifications put forward in 2003 by the EC, however, do not tackle the main issues we discussed above.

These objectives can be achieved by complementing the SGP with an expenditure rule, that is easy to monitor and allows governments to own their own policy and the EU Commission to act as an outside monitoring body, even better if complemented by an independent national technical body providing a view on the computation of potential growth and assessing policy measures of the government.

In Coricelli and Ercolani (2004) we argue that a more suitable rule for an enlarged and more heterogeneous EU would be a simple expenditure rule, according to which expenditures would grow at the same rate as that of potential output (see Box 2). Interestingly, the Czech Republic has introduced a medium-term fiscal program with an expenditure rule.

From the rule described in Box 1 it is apparent that when real GDP growth will be equal to potential GDP growth, and inflation equals its target level (that could be the ECB target rate when the country is a member of the Eurozone), actual deficit equals its target value. When output growth falls short of potential growth, there will be a budget deficit, while a surplus will emerge when output growth is above its potential growth. The rule embodies an automatic "growth dividend": in good times the country accumulate surpluses that can be spent in bad times, ensuring a stable average level of debt-to-GDP ratio. Whether the rule is consistent with the 3% Maastricht ceiling on budget deficit depends on the magnitude of the deviations of output growth from its potential rate. What is more important is that if the country follows the above rule it cannot be blamed for lax fiscal policy. The worsening of budget deficits will entirely results from a downturn in the economy and not from a discretionary loosening of fiscal policy. Monitoring of fiscal policy would be very simple because the rule implies specific nominal values for expenditure. In summary, the framework proposed allows for an evaluation of fiscal stance that is superior to alternative indicators such as the cyclically-adjusted budget deficit. The proposed measure of discretionary fiscal policy better reflects discretionary policy decisions by the government.

5. Conclusions

In this paper we wanted to add the dimension of the enlargement to the already heated debate on EU fiscal rules. From the analysis it emerged that the main drawbacks of current rules from the perspective of NMs countries reveal fundamental shortcomings of the EU fiscal framework, and especially its implementation.

Enlargement makes even more visible these shortcomings. However, even more important is the fact that fiscal discipline is a key element for a successful and fast convergence of NMs to income levels of the EU-15 countries. Such discipline ultimately rests on credible commitment by national authorities. Indeed, the heterogeneous experience of NMs, with two distinct groups of countries is telling. The Baltic states have followed prudent fiscal policy and a program of reduction of the size of the government. This process has been accompanied by high rates of growth of the economy and macroeconomic stability, that has allowed them to enter the fast track of

Box 2: A medium term framework with an expenditure rule

Primary expenditure grows in line with the growth rate of potential output, while target revenue, at unchanged tax rates, grows in line with actual output. Denoting with a (*) target variables, with y real GDP growth and π the inflation rate, we can write the rule as follows:

Target expenditure:

$$g^* = g_{t-1} \left[\frac{1 + y_t^* + \pi_t^*}{1 + y_t + \pi_t} \right]$$

Target revenues:

$$\tau^* = \tau_{t-1} \left[\frac{1 + y_t^* + \pi_t^*}{1 + y_t + \pi_t} \right]$$

where we have assumed that the output elasticity of revenues is equal to one.

Target budget deficit:

$$d^* = g^* - \tau^*$$

With an estimation of potential output that implies that deviations of actual output from potential have zero mean (such as for instance the Hodrick-Prescott filter used until recently by the EU Commission), on average actual output will be equal to its potential level. As a result, on average, actual deficit will be equal to the target. Actual expenditures is a function of expected output and inflation and of a discretionary component, while revenues follow the actual behavior of output and inflation and the discretionary changes in tax rates. Thus, actual expenditures and revenues are as follows:

$$\tau^* = \tau_{t-1} \left[\frac{1 + y_t + \pi_t + \tau_t^d}{1 + y_t + \pi_t} \right]$$

$$g = g_{t-1} \left[\frac{1 + y_t^e + \pi_t^e + g_t^d}{1 + y_t + \pi_t} \right]$$

while the budget deficit, in terms of actual GDP

$$d = g - \tau$$

where e stands for expected values and d for discretionary.

One can identify a measure of discretionary fiscal policy as the difference between the actual and the target budget deficit.

$$DP_t = \left[\frac{(g_{t-1}g_t^d - \tau_{t-1}\tau_t^d) + g_{t-1}(y_t^e - y_t^* + \pi_t^e - \pi_t^*)}{1 + y_t + \pi_t} \right]$$

The “true” discretionary policy is obtained by subtracting to DP the effects of forecast errors

$$DP_t^{true} = DP_t - \left[\frac{g_{t-1}(y_t^e - y_t^* + \pi_t^e - \pi_t^*)}{1 + y_t + \pi_t} \right] = \frac{(g_{t-1}g_t^d - \tau_{t-1}\tau_t^d)}{1 + y_t + \pi_t}$$

accession to the Eurozone. Slovenia has followed a similar path, although it is still in the middle of an internal debate on tax reform and on the role of the state in the economy. By contrast, Central European countries have shown growing budget deficits and raising debt levels. Starting from an oversized government, these countries face a challenge to adjust their fiscal accounts in the near future, not only as a precondition for entry in the Eurozone, but also as a policy to support a faster rate of growth of their economy.

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