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An Comhchoiste um Ghnóthaí Eorpacha

An Ceathrú Tuarascáil Déag

**AONTAS AIRGEADAÍOCHTA EORPACH:
DÚSHLÁIN AGUS ROGHANNA**
(Rapporteur: An Seanadóir Paschal Donohoe)

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HOUSES OF THE OIREACHTAS

Joint Committee on European Affairs

Fourteenth Report

**EUROPEAN MONETARY UNION: CHALLENGES
AND OPTIONS**
(Rapporteur: Senator Paschal Donohoe)

July 2010

Joint Committee on European Affairs
European Monetary Union: Challenges and Options

Table of Contents

Decision of the Joint Committee	3
Executive Summary	3
1. Introduction	11
Ireland and the New National Question.....	11
2. The Launch of the Stability and Growth Pact	13
Budgetary Choices and Deficit Bias	13
Deficit Bias in the European Monetary Union.....	13
The Maastricht Treaty Convergence Criteria	14
The Stability and Growth Pact	15
3. The Stability and Growth Pact 1999 to 2010	19
The Launch of the Stability and Growth Pact.....	19
Economic Downturns and the SGP	19
French and German experience with the SGP	21
Structural Budget Deficits and EMU.....	22
The 2005 Reforms	23
Experience of the ‘Reformed’ Pact.....	24
The Performance of Greece, Ireland and Spain	25
The emergence of structural deficits across the Eurozone	27
4. Reforming the Pact	29
Criticisms of the SGP.....	29
Reforms	31
Institutional and Procedural Reforms	31
The Quality of Public Finances.....	33
The Debt Criterion	34
5. Conclusions and Recommendations	37

Appendices

A: References

B: List of members of the Joint Committee

C: Orders of Reference of the Joint Committee

Joint Committee on European Affairs
European Monetary Union: Challenges and Options

Decision of the Joint Committee

The Joint Committee on European Affairs at its meeting on 17 February 2010 considered a proposal by Senator Paschal Donohoe to produce a report for the Joint Committee on European Monetary Union: Challenges and Options.

It was proposed that the report would

- Review the challenges facing European Monetary Union due to the current financial crisis,
- analyse them with reference to small open economies such as Ireland and
- detail options for the successful operation of Monetary Union in the future.

It was agreed at that meeting that Senator Donohoe, acting as Rapporteur to the Joint Committee should proceed to produce such a report.

Decision of the Committee

The Joint Committee, at its meeting of 13 July 2010, agreed that this report be laid before both Houses of the Oireachtas and thanked Senator Donohoe for the work done in its preparation.

The Joint Committee also agreed to call for a debate in both Houses on the Report.

Bernard J. Durkan
Chairman
13 July 2010

Joint Committee on European Affairs
European Monetary Union: Challenges and Options

Executive Summary

1. Introduction – Our New National Question

- The New National Question is about how we maintain our prosperity and security, when so many of the national policy tools that deliver more immediate results, such as exchange and interest rate adjustments are no longer available to us.
- A concrete manifestation of this new challenge is the current debate in relation to the reform of the Stability and Growth Pact.
- This report firmly argues that Ireland has nothing to fear from future reforms. We should be assertive in stating that a pact that allows the national delivery of strong national finances is in our national interest. We must also be assertive in stating that the current suggested reforms are a missed opportunity to broaden the measures of economic success and to recognise good budgetary practice in Member states.

2. The Launch of the Stability and Growth Pact

- In monetary union poor fiscal decisions taken by one or a group of countries can generate consequences which impact on the entire union area via higher interest rates, higher inflation and ultimately bail-out costs.
- The Maastricht Treaty attempted to deal with these issues by requiring aspirant members of the euro area to satisfy a series of criteria which became known as the Maastricht Convergence Criteria. In addition to criteria relating to inflation, interest rates and exchange rate stability, EU member States were also required to meet two fiscal criteria, namely that budget deficits should not exceed 3 percent of GDP and that debt-to-GDP ratios should be at most 60 percent or, if above that level, declining towards the reference value.

- The Stability and Growth Pact was introduced to maintain fiscal discipline once Member States joined the eurozone.

3. The Stability and Growth Pact 1999 to 2010

- In its initial years the SGP appeared to maintain the fiscal consolidation achieved under the Maastricht Convergence Criteria with the majority of countries recording either a budget surplus or a deficit comfortably within the 3 percent limit. However, this was against the backdrop of a benign economic environment.
- By 2003 five euro economies had deficits in excess of the 3 percent reference value with the overall deficit for the euro area rising from an almost balanced position in 2000 to 3.1 percent of GDP in 2003.
- As a result, the Excessive Deficit Procedure was invoked against Portugal and Germany in 2002, France in 2003, the Netherlands and Greece in 2004 and Italy in 2005.
- By late 2003 it became clear that their deficits were continuing to rise and that neither France nor Germany would meet their targets. Neither Member State faced sanction due to this non compliance. These cases pointed to obvious credibility and enforcement problems for the SGP. If the two largest euro area economies fail to comply with the rules then why should smaller countries do so?
- Most Member States continued to experience rising structural deficits. Progress was made in reducing structural debt levels. This modest trend towards fiscal consolidation was dramatically reversed by the financial crisis and severe economic downturn in 2008 and 2009.
- Nearly all euro area economies have recorded structural deficits since 2008 implying that deficits would persist even if an upswing in economic activity removed the cyclical components of the actual deficit.

4. Reforming the Pact

- Criticisms of the SGP can be grouped under four headings: enforcement and surveillance; inflexibility; asymmetry; and its impact on public investment and economic growth.
- Not only did the Council fail to enforce the full weight of the EDP against France and Germany in 2003 but between 2002 and 2006, years of moderate to good economic growth, five Member States (France, Germany, Greece, Italy and Portugal) had deficits consistently above or very close to the 3 percent threshold but sanctions were not imposed in any case.
- The SGP has also been criticised on the grounds that it lacks flexibility in that it focuses on the actual deficit without consideration of the underlying circumstances and differences between Member States.
- The SGP is asymmetric in that it penalises countries for running excessive deficits during recessions but provides few incentives for enhanced fiscal consolidation during periods of high and rapid growth.
- While the 2005 reforms allow for 'other relevant factors' such as expenditure on research and development to be taken into account when assessing budgetary positions, compliance with the Close to Budget Surplus (CBS) rule still implies that expenditures on capital projects which may improve the economy's productive capacity must be financed from current revenues raised from taxation on the current generation. As a consequence, the SGP may act as a disincentive to undertake public investment projects to the detriment of future generations.
- Proposed changes to the SGP can be classified under three headings: institutional and procedural reforms; the quality of public finances; and greater focus on the debt criterion.
- The European Council has now established a Task Force on Economic Governance with the objective of "strengthening budgetary discipline through the Stability Pact". This work has focused heavily on the role of sanctions in delivering fiscal compliance.
- One of the most commonly discussed changes to the SGP is the so called golden rule proposal which requires that the overall budget be split into two components, a current account and a capital account. Under the golden rule the current budget should be kept

- Many commentators have proposed modifications to the SGP which would let the threshold value for the deficit vary inversely with the debt ratio so that countries with low debt-to-GDP ratios can be permitted higher deficits and vice-versa.

5. Recommendations and Conclusions

- A stability pact that delivers fiscal coordination and consolidation of public finances is essential to the success of monetary union with the recent experience of Greece, and to a lesser extent Ireland and Spain, clearly demonstrating that fiscal ill discipline in even small to medium sized economies can be highly destabilising and costly to the monetary union as a whole.
- Even before the recent global downturn and financial crisis it was clear that the Europe's Stability and Growth Pact was not delivering these benefits and that there was a clear case for reform.
- The current European economic crisis makes it very likely that the Pact will be reformed by the end of this year. Ireland should not fear a reformed pact. The emergence of a substantial current borrowing requirement and the development of a structural budget deficit are posing massive challenges to our country. Any process which reduces the possibility of this happening again in the future should be embraced.
- However, the proposals published recently by the European Commission and under active consideration by the European Council's Task Force on Economic Governance which aim to reform the Pact have serious omissions that must be addressed. These omissions can be summed up as the need for more 'carrot' as well as a more effective 'stick'.
- To improve surveillance procedures, national governments should establish National Fiscal Councils charged with the role of assessing budgetary policies and providing independent forecasts for economic growth and government revenues and expenditures. These steps should firstly be taken at national level.

- The new pact must recognise overall levels of national debt and display flexibility for economies with more sustainable debt levels. A 'one size fits all' debt rule does not recognise sustained levels of responsible debt management.
- The reformed pact should track the development of structural budget deficits and make more allowances for growth promoting policies that can lead to a reduction in structural deficit levels.
- Measures of 'real economic performance' such as productivity, competitiveness and labour market policies must be included in a reformed pact. This is essential.

1. Introduction

Ireland and the New National Question

Where do you stand on the National Question? This apparently harmless interrogation – meaningless to anyone outside the island of Ireland - has historically been code in this country for so many other, much bigger questions.

In an Irish and British context, as we have moved slowly towards an era of greater stability, it no longer carries the significance it once did.

But I believe that, in its place, Ireland faces a New National Question; one that is no less significant, its ramifications no less overwhelming, than that, which once confronted earlier generations.

The question itself is not, in fact, new: it still addresses the problem of how to create a State which is secure, free and prosperous in an environment of political and economic uncertainty.

The context has changed utterly. Ireland is no longer defined in terms of its relationship with Britain and the North. Now, the National Question we face is about our relationship to EU and the wider world.

Our economy is profoundly integrated with the global economy. However this integration took place during a time of exceptional growth. In contrast, tempestuous global events are impacting on Ireland's ability to grow our economy.

The New National Question is about how we maintain our prosperity and security, when so many of the national policy tools that deliver more immediate results, such as exchange and interest rate adjustments are no longer available to us.

This theme was explored by the economist Michael O'Sullivan in 2006 at the peak of our exuberance. As we deal with what feels like a well of despair we must renew this analysis to find new solutions. A concrete manifestation of this new challenge is the current debate in relation to the reform of the Stability and Growth Pact. Other factors feeding into to this

New National Question include global financial regulation, the liberalisation of trade, growth in the world economy driven by the G8 and G20 countries and the affects of climate change.

However recent events have demonstrated the weakness of the Stability and Growth Pact and made reform an immediate priority. A fiscal crisis in one member state and severe budgetary challenges in many other European economies have raised the spectre of the sovereign debt funding difficulties and profoundly questioned the credibility of the Euro and it's economic institutions.

The need to avoid this happening in the future makes it very likely that the Stability and Growth Pact will be reformed and strengthened. At risk, is not just the support for the European project amongst fiscally strong member states, but the future credibility and strength of the euro. But, as one writer has noted:-

“In view of the overarching hopes and expectations that have been invested in the Euro, mere survival is not enough. EMU must provide a genuine route for European countries to improve their economic performances, in a century that will see increasing strength from China, India and other fast developing economies. If that is not the case, the gap between more and less successful members of monetary union will widen further. And the Euro will face the danger of fragmentation, with either strong or weak countries separating from the system...”

(David Marsh, The Euro, The Politics of the New Global Currency, 2009)

This report firmly argues that Ireland has nothing to fear from future reforms. We should be assertive in stating that a pact that allows the national delivery of strong national finances is in our national interest. We must also be assertive in stating that the current suggested reforms are a missed opportunity to broaden the measures of economic success and to recognise good budgetary practice in Member states.

A debate is needed on these matters within the Oireachtas to inform current Government strategy. This report hopes to make a contribution on this dimension on our new National Question.

It does this by reviewing the need for such a pact within a monetary union. It then analyses the performance of the current arrangement. Section 4 details the different options for reform. The report concludes with key points on this juncture in our economic history and recommendations to the Government.

2. The Launch of the Stability and Growth Pact

Budgetary Choices and Deficit Bias

Governments tend to spend too much and tax too little when times are good and do the opposite when times are bad. This leads to excessive deficits and rising debt ratios. This phenomenon is called *deficit bias*. It can arise because policy makers and their constituencies may be subject to *fiscal illusion* and do not fully recognise that decisions taken today may require higher taxation or lower spending at some time in the future.

For example, rising tax revenues during a boom may lead governments to grant relatively large public sector wage and salary increases. But such increases need to be financed into the future, requiring that the economy and tax revenues continue to grow at an adequate pace. However when the economy moves into recession tax revenues decline but the higher level of government expenditure remains, leading to a higher deficit and an increased public sector debt.

Excessive deficits and rising debt ratios lead to economic instability and have important national implications. For individual countries the sustainability problems associated with high deficit and debt ratios may necessitate fiscal contraction during recessions to prevent further increases in public borrowing. In short fiscal, policy will be pro-cyclical rather than counter-cyclical with government cutting expenditure and/or increasing taxation leading to deeper and more prolonged recessions.

Deficit Bias in the European Monetary Union

In a monetary union such as the euro area poor fiscal planning by individual countries can also create problems for other countries. The sharing of a single currency and a central bank (monetary policy) but the lack of co-ordination of taxation and spending policies (fiscal policy) can allow the spreading of national economic problems to other members of the monetary union. This is most likely to happen in two different ways.

First, fiscal developments are an important input to European Central Bank inflation forecasts and have a bearing on interest rate decisions. To the extent that excessive fiscal deficits lead to higher inflation they may cause the ECB to increase interest rates more than

it would otherwise do leading to lower investment, an overvalued exchange rate and lower economic growth.

Second, deficits imply continuous government borrowing and, if economic growth is low, rising debt-to-GDP ratios leading to potential debt sustainability problems imposing an additional burden on both current and future generations. For example, consider an EMU country such as Greece which runs excessive deficits leading to very high debt ratios. If international bond markets believe that Greece does not have the political capacity to extricate itself by taking the necessary corrective action they become reluctant to finance the Greek deficit except at very high interest rates. As a result Greek bond prices plummet leading to domestic banking problems and severe budgetary problems. To prevent a collapse of the Greek financial system, which could adversely affect the euro's international value and perhaps spark contagion effects in other high deficit countries the euro area will have to act either by the ECB buying large quantities of Greek bonds and/or partner countries underwriting Greek debt by offering loans.

Regardless of the action taken the costs are borne by partner countries in the euro area as a whole rather than by just the 'offending' country. In short, poor fiscal decisions by one or a group of countries can generate consequences which impact on the entire euro area via higher interest rates, higher inflation and ultimately bail-out costs.

The Maastricht Treaty Convergence Criteria

The Maastricht Treaty attempted to deal with these issues by requiring aspirant members of the euro area to satisfy a series of criteria which became known as the Maastricht Convergence Criteria. In addition to criteria relating to inflation, interest rates and exchange rate stability EU member States were also required to meet two fiscal criteria, namely that budget deficits should not exceed 3 percent of GDP and that debt-to-GDP ratios should be at most 60 percent or if above that level declining towards the reference value.

Adherence to the Maastricht Convergence Criteria enabled most EU countries to successively deal with their deficit problems with the euro area deficit falling from over 4 percent in 1991 to 2.6 percent in 1997. Most significantly, by setting EMU membership as its primary target Italy successfully adhered to tight monetary and fiscal policies and reduced its deficit from over 10 percent in 1991 to less than 3 percent in 1997.

While the Maastricht Convergence Criteria are often seen as a series of conditions which Member States had to satisfy to be admitted to full EMU Article 104 the Treaty also required that all Member States should continue to avoid excessive deficits (above 3 percent) and that failure to comply with this objective can trigger an Excessive Deficit Procedure, or EDP, under which the EU Council of Finance Ministers, commonly known as ECOFIN, had the discretion to impose financial penalties on errant countries.

The Stability and Growth Pact

Without doubt the 'prize' of being admitted to monetary union proved to be a powerful incentive for many countries to restore fiscal discipline and reduce their deficits in the run-up to the introduction of the euro in 1999. However several countries and especially Germany were concerned that once a Member State was deemed to satisfy the convergence criteria the incentives provided by being admitted to the new monetary union would diminish and, despite the provisions of Article 104, the pressure to maintain fiscal discipline would be correspondingly weakened.

Following initial negotiations at the December 1996 Dublin summit the European Council meeting in Amsterdam in June 1997 passed a series of regulations designed to strengthen the fiscal provisions of the Maastricht Treaty and to develop a rules based approach to fiscal policy aimed at counteracting the phenomena of *deficit bias*. The resulting new agreement was named the Stability and Growth Pact (SGP). This pact was a political agreement that would require political will to implement it.

As originally designed the SGP consisted of two "arms", the preventive arm and the corrective arm. The preventive arm required that countries should achieve a budget "close to balance or in surplus" over the medium-term which is usually interpreted as ensuring that the deficit is at most zero when the economy is at its full employment and that the budget is in surplus when the economy is growing at a rate above that necessary to maintain full employment. Providing the deficit does not breach the 3 percent reference value there is scope for discretionary measures when the economy slows down and recession sets in. That is, by running a surplus during the upswing and a deficit during the downswing fiscal policy can operate in a counter-cyclical manner.

In addition, the SGP requires that countries submit an annual stability programme to the Commission and ECOFIN. These programmes should provide details of current and future fiscal policy and explain how the medium-term objective is to be met. If ECOFIN judges that the provisions detailed in a country's stability programme to be inconsistent with the SGP's medium-term objective it can issue an early warning and recommend corrective actions.

The corrective arm of the SGP gives greater clarity to the EDP as outlined in the Treaty. Once an excessive deficit results in the EDP being triggered the errant country is required to introduce corrective action and bring its deficit into line with the 3 percent reference value within a given time period. If, however, the country can demonstrate that the breach is due to *exceptional and temporary circumstances* and the ratio remains close to the reference value it may claim exemption from the EDP.

When exemptions are not granted, the SGP permits ECOFIN to apply sanctions in the form of non-interest bearing deposits which become fines if non-compliance persists for a further two years. Following a dispute between the Commission, the Council and the euro area's two largest economies France and Germany which were both reporting deficits above 3 percent, the corrective arm of the SGP was modified by a series of reforms agreed by the Council in 2005.

These changes, which are discussed in the following section, were largely designed to give the Council greater discretion in determining whether deficits above the 3 percent threshold value are indeed excessive and necessitate initiating the EDP. In particular, the Council can now take factors such as expenditure on investment programmes, R&D and pension reforms into account when assessing country fiscal positions.

However scepticism existed even at the time of the instigation of these reforms with one commentary noting:

"It remains to be seen, however, whether the proposals will satisfactorily increase the incentives for compliance. In this context it is really the political will of member countries that counts."

(Treaty Reform : consequences for monetary policy, Deutsche Bank Research Note, October, 2007)

That the SGP has been unsuccessful in maintaining low deficits and fiscal stability in the euro area is now all too evident. As of 2009 the majority of euro countries were running deficits in excess of the 3 percent reference value and in some cases by multiples of that figure and

most estimates suggest that this situation will persist over 2010-11. The following section of this Report will now review the overall performance of the SGP since 1999 and attempts to identify its key weaknesses.

3. The Stability and Growth Pact 1999 to 2010

The Launch of the Stability and Growth Pact

The Maastricht Convergence Criteria provided a strong incentive for individual countries to consolidate their fiscal positions prior to the launch of the single currency with governments in countries such as Belgium, Italy, Portugal and Spain able to maintain public and political support for tight monetary and fiscal policies by holding up the carrot of euro entry.

This incentive was, however, a once-off. It vanished with the launch of the single currency in January 1999 and was replaced by the preventive and corrective arms of the SGP. The prize of euro entry to maintain fiscal discipline by governments was now gone. In short, countries now faced a possible trade-off between compliance with the SGP and using fiscal policy to stabilise the domestic economy or deliver political commitments. During periods of rapid economic growth and increasing revenues this trade-off was not binding but would bite most heavily when the domestic economy moved into recession and euro area governments, now without recourse to monetary and exchange rate policies, would be forced to rely on fiscal policy as the only viable domestic stabilisation instrument.

Economic Downturns and the SGP

Table 1 summarises the fiscal record of euro area countries since the single currency was launched in 1999. In its initial years the SGP appeared to maintain the fiscal consolidation achieved under the Maastricht Convergence Criteria with the majority of countries recording either a budget surplus or a deficit comfortably within the 3 percent limit. While apparently consistent with the objectives of the SGP this initial success must be judged against the background of relatively benign economic conditions with euro area real GDP growing by 4 percent in 2000 and by 4.1 percent in France and 3.5 in Germany, the two largest and most important euro economies.

Table 1 Government Budget Balances**(% of GDP Surplus + Deficit -)**

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Austria	-2.3	-1.7	0	-0.7	-1.4	-4.4	-1.7	-1.5	-0.4	-0.4	-3.4
Belgium	-0.6	0	0.4	-0.1	-0.1	-0.3	-2.7	0.3	-0.2	-1.2	-6
Finland	1.6	6.8	5	4	2.4	2.3	2.7	4	5.2	4.2	-2.2
France	-1.8	-1.5	-1.5	-3.1	-4.1	-3.6	-2.9	-2.3	-2.7	-3.3	-7.5
Germany	-1.5	1.3	-2.8	-3.7	-4.0	-3.8	-3.3	-1.6	0.2	0.0	-3.3
Greece	-3.1	-3.7	-4.5	-4.8	-5.6	-7.5	-5.2	-3.6	-5.1	-7.7	-13.6
Ireland	2.7	4.8	0.9	-0.3	0.4	1.4	1.6	3	0.1	-7.3	-14.3
Italy	-1.7	-0.8	-3.1	-2.9	-3.5	-3.5	-4.3	-3.3	-1.5	-2.7	-5.3
Luxembourg	3.4	6	6.1	2.1	0.5	-1.1	0	1.4	3.6	2.9	-0.7
Netherlands	0.4	2	-0.2	-2.1	-3.1	-1.7	-0.3	0.5	0.2	0.7	-5.3
Portugal	-2.8	-2.9	-4.3	-2.8	-2.9	-3.4	-6.1	-3.9	-2.6	-2.8	-9.4
Spain	-1.4	-1	-0.6	-0.5	-0.2	-0.3	1	2	1.9	-4.1	-11.2
<u>Euro area</u>	<u>-1.3</u>	<u>0.1</u>	<u>-1.8</u>	<u>-2.5</u>	<u>-3.1</u>	<u>-2.9</u>	<u>-2.5</u>	<u>-1.3</u>	<u>-0.6</u>	<u>-2.0</u>	<u>-6.3</u>

Source: Eurostat

However, with the onset of the economic slowdown in 2002-2004 this situation changed and deficits started to rise across the euro area. Over this period real GDP declined to an average growth rate of 1.2 percent per annum in the euro area as a whole and by 1.3 and 0.2 percent in France and Germany respectively, and as economic conditions deteriorated the combination of automatic stabilisers in some cases and the use of discretionary fiscal policy in other cases led to increased deficits across the euro area.

By 2003 five euro economies had deficits in excess of the 3 percent reference value with the overall deficit for the euro area rising from an almost balanced position in 2000 to 3.1 percent of GDP in 2003. As a result the Excessive Deficit Procedure was invoked against Portugal and Germany in 2002, France in 2003, the Netherlands and Greece in 2004 and Italy in 2005.

The ECB retrospectively noted that:

“This return to higher deficits in the euro area needs to be seen in a context of persistently poor economic growth and, more importantly, consolidation fatigue, which started soon after the launch of the single currency. Moreover, improving nominal budget balances in the early years of the Pact’s implementation initially contributed to the false perception that fiscal positions were getting better”.

(European Central Bank, 2006)

Ireland was actually the first country to be subject to an early warning under the provisions of the SGP. In 2000 the government’s Stability Programme committed the country to a 4.3 percent surplus for 2001 but the actual surplus turned out to be 0.9 percent of GDP. As a result ECOFIN judged Irish fiscal policy to be pro-cyclical and recommended a strategy more consistent with the objectives of the pact.

French and German experience with the SGP

While all breaches of the 3 percent reference value are potentially damaging to fiscal consolidation, the cases of France and Germany proved to be of particular significance. When the EDP was triggered both countries were given until 2004 to take the necessary corrective actions. However by late 2003 it became clear that their deficits were continuing to rise and that neither France nor Germany would meet their targets.

The Commission proposed extending the deadline to 2005 and that ECOFIN should issue notices to both countries that fines would be imposed if their deficits were not reduced. The Council rejected these proposals and although the Commission’s view was subsequently upheld by the European Court of Justice no action was taken against France and Germany and the EDPs against them were effectively put into abeyance.

The cases of France and Germany over 2002-2004 pointed to obvious credibility and enforcement problems for the SGP. If the two largest euro area economies fail to comply with the rules then why should smaller countries do so?

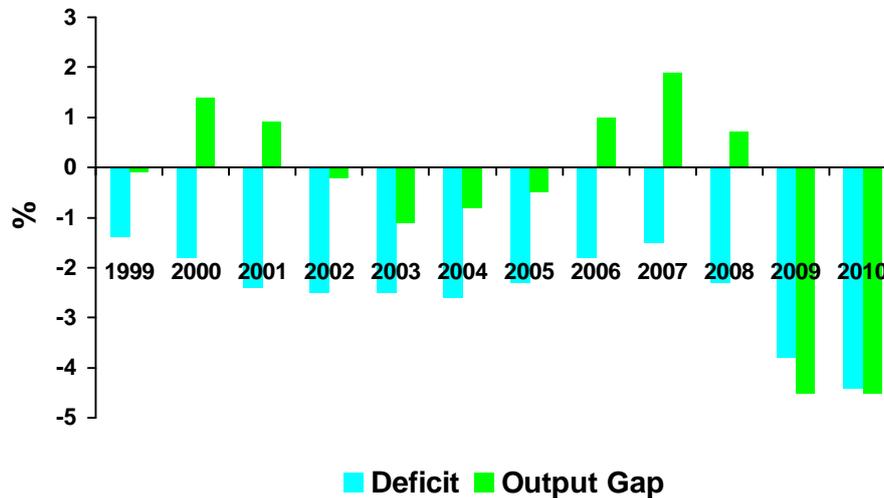
Structural Budget Deficits and EMU

In addition to avoiding deficits in excess of 3 percent the SGP also requires each country to maintain a budget which is close to balance or in surplus over the medium term. While it is not precisely defined this so-called CBS (Close to Budget Surplus) rule is generally interpreted to mean that the actual budget balance should be at least zero when the economy is at potential or full employment. The importance of the CBS rule is that compliance leaves scope for automatic stabilisers and perhaps discretionary fiscal policy to operate within the 3 percent threshold value when economic activity slows and the economy moves into recession. Further, as the structural or cyclically-adjusted deficit measures the actual deficit at full employment the CBS rule can also be interpreted as requiring countries to target a balanced structural position.

Table 2 charts the euro area structural deficit and cyclical deviations from potential output, known as the output gap, since the introduction of the euro in 1999. The output gap is defined as the deviation of actual GDP from potential or full-employment GDP. A positive output gap implies that GDP is above its potential level while a negative value indicates a downturn. As the structural deficit measures the actual deficit at full employment, compliance with the CBS rule means that the structural balance should be zero or positive (a surplus) when the economy is running at or above full employment.

However as the below table clearly indicates that over the 'boom' years 2000 and 2001 when the output gap was positive, the structural deficit was actually increasing. In fact in 2001 only Finland and Luxembourg recorded a structural surplus with the remaining countries in deficit. This failure to comply with the CBS rule and to correct for structural imbalances in good years is one important reason why fiscal policy has tended to be pro-cyclical under the SGP (Pisani-Ferry *et. all.*, 2008). Crucially if the government budget is in deficit at full employment then an adverse shock which reduces tax revenues will most likely require fiscal retrenchment to prevent the deficit breaching the threshold value once recession sets in.

Table 2
Structural Deficit and the Output Gap:
Euro Area



Source: OECD Economic Outlook 2009

The 2005 Reforms

The evidence from these early years suggests that the SGP was not working as intended. Not only were the largest economies in breach of the reference value but the Council failed to enforce the EDPs raised against them and there is also clear evidence of the emergence of structural deficits and pro-cyclical policy across the euro area. In an attempt to address these issues the SGP was reformed in 2005 with changes to both the preventive and corrective arms.

On the preventive side the 3 and 60 percent ratios were retained but the CBS rule was modified to allow all Stability and convergence Programmes to include “medium-term country specific budgetary objectives [which] may diverge from the requirement of a close to balance or in surplus position” with the provision that they also provided a “safety margin with respect to the 3 percent of GDP government deficit ratio.”¹

¹ Council Regulation 1055/2005

However when a deficit is above but 'close to' 3 percent the reforms gave the Council greater discretion to deem any excess to be 'temporary' or 'exceptional' if it is judged to result from severe economic conditions and not trigger the EDP. In addition countries were required to reduce their structural deficits by 0.5 percent per annum during periods of strong economic growth.

On the corrective side greater discretion was given to the Council in determining 'exceptional circumstances'. In its initial form the SGP gave an exemption from the EDP if real GDP declined by more than 2 percent and allowed countries to argue for an exemption if real GDP was declining at a rate between 0.75 and 2 percent per annum.

The reformed Pact allowed the Council greater discretion in determining whether a country is experiencing a severe economic downturn and permits 'other relevant factors' to be taken into account in deciding if a country's deficit is to be deemed excessive. These factors includes expenditure on investment programmes, R&D and pension reform. Also the Council was given discretion to extend the time frame for corrective action if it had evidence that the errant country was making satisfactory progress towards eliminating an excessive deficit or experiencing slower than expected economic growth.

Experience of the 'Reformed' Pact

As illustrated in Figure 1 the 2005 reform package had the advantage of being introduced at a time when the euro area economy was moving into the expansionary phase of the business cycle. Most countries reduced their actual deficits and by 2007 only Greece had a deficit above 3 percent of GDP. Progress was also made on reducing structural deficits with the overall euro area structural deficit falling from 2.6 percent to 1.5 percent of potential GDP between 2004 and 2007.

This modest trend towards fiscal consolidation was dramatically reversed by the financial crisis and severe economic downturn in 2008 and 2009. With the exceptions of Finland and Luxembourg all euro area counties were reporting deficits in excess of 3 percent of GDP in 2009 with the most severe breeches occurring in Greece, Ireland and Spain. Following this rapid deterioration in fiscal deficits the Council acted by declaring EDPs against six euro area countries in December 2009 (Austria, Belgium, Germany, Italy, the Netherlands and Portugal) and against an additional four in April 2010 (France, Ireland, Germany and Spain)

but used the enhanced flexibility given under the 2005 reforms and extended the adjustment period for corrective action to four years in all cases.

The Performance of Greece, Ireland and Spain

While the majority of euro area countries are now in breach of the 3 percent threshold most attention has been given to the cases of Greece, Ireland and Spain. There are, however, important differences between these countries. Table 3 presents summary data for real GDP growth rates and the actual and structural deficits over 1999 to 2009.

Table 3. Greece, Ireland and Spain									
Summary Data 1999-2009									
	Real GDP Growth Rate			Government Deficit			Structural Deficit		
	% per annum			% of GDP			% of Potential GDP		
	1999-07	2008	2009	1999-07	2008	2009	1999-07	2008	2009
Greece	4.2	-2.0	-3.0	-5.0	-7.7	-13.6	-4.62	-7.5	-10.4
Ireland	6.0	-3.0	-7.6	1.6	-7.3	-14.3	0.68	-7.1	-8.9
Spain	3.6	0.9	-3.6	0.1	-4.1	-11.2	-0.19	-3.5	-6.8

Source: OECD Economic Outlook 2009/Eurostat

In the case of Greece it is now clear that there is a history of misreporting economic data creating a serious credibility issue for the Greek economy (European Commission, 2010). Although provisional estimates by Eurostat indicate that real GDP grew by approximately 4 percent per annum since joining the euro and that the recent global economic downturn has had a limited effect on the economy (European Commission, 2009), the data in Table 2 shows that the government deficit has been continually in excess of the 3 percent reference value and that the structural balance has been persistently negative and increasing over the last decade. As the structural balance 'cleans out' cyclical and once-off variations in government revenue and expenditure a persistently negative value indicates that Greek public finances were on an unsustainable trajectory long before the global downturn hit in 2008.

In short, the Greek fiscal crisis is the result of poor control and mismanagement of the public finances rather than a severe economic downturn. Once this was fully realised in early 2010 international financial markets became reluctant to buy Greek bonds except at prohibitive interest rates and thereby necessitated the EU/IMF 'bail-out' in May 2010.

By contrast the fiscal records of Ireland and Spain have, until recently, been largely consistent with the requirements of the SGP with government budget balances averaging +1.6 and +0.1 percent of GDP respectively over 1999 to 2007. Also, the Irish debt to GDP ratio fell from 48 to 29 percent and the Spanish ratio from 62 to 32 percent over the same period. Greece, on the other hand, experienced an average deficit of 5 percent and its debt ratio increased from 94 to 96 percent of GDP.

However, as shown in Table 2 Ireland and to a lesser extent Spain were more severely affected by the banking crisis and global economic downturn in 2008 and 2009 with Irish real GDP declining by 7.6 percent in 2009 and Spanish real GDP by 3.6 percent. As a consequence of the downturn Irish unemployment increased from 4.6 percent of the labour force in 2007 to 11.9 percent in 2009 and Spanish unemployment from 8.3 to 18 percent over the same period.

In both cases the increases in government deficits cannot be fully attributed to automatic stabilisers triggered by a cyclical downturn and deteriorating economic conditions. Spain, for example, introduced a series of discretionary fiscal stimulus packages in 2008 and 2009 which amounted to approximately 3 percent of GDP and proved to be a significant factor underlying the subsequent increase in the government deficit (European Commission 2009) Also both countries were experiencing property booms which when they collapsed had serious implications for the banking sector and the public finances.

In Ireland the property boom peaked in 2006 when property-related taxes accounted for approximately 17 percent of all government tax revenues and 4.5 percent of GDP. Two years on these figures had declined to 7 and 1.5 percent respectively leaving a large hole in the public finances. This has also caused severe problems for the banking sector that financed the boom with loans secured by land and property whose market values are now a fraction of the original valuations on which the loans were granted.

More importantly since 2007 both Ireland and Spain have been experiencing emerging structural deficits which have, certainly in the Irish case, resulted from a severe loss of

competitiveness, inappropriate policies which narrowed the tax base and an over reliance on the property and construction sectors as sources of government revenue.

The emergence of structural deficits across the Eurozone

However, Greece, Ireland and Spain are not alone in experiencing structural imbalances. As shown in Table 4 nearly all euro area economies have recorded structural deficits since 2008 implying that deficits would persist even if an upswing in economic activity removed the cyclical components of the actual deficit.

Table 4 Structural Deficits						
(% of Potential GDP)						
	2006	2007	2008	2009	2010	2011
Austria	-1.8	-1.4	-1.4	-3.2	-3.2	-3.4
Belgium	-0.4	-1.1	-1.5	-3.0	-2.1	-1.7
Finland	3.2	4.2	4.1	1.2	-0.5	-1.5
France	-2.7	-3.5	-4.0	-6.7	-6.6	-6.1
Germany	-1.8	-0.8	-1.1	-2.1	-3.8	-3.6
Greece	-3.6	-4.5	-7.5	-10.4	-6.4	-6.3
Ireland	2.0	-1.4	-7.1	-8.9	-8.3	-8.4
Italy	-3.6	-2.2	-2.6	-2.8	-2.5	-2.7
Luxembourg	0.7	2.1	1.6	-0.5	-2.1	-1.9
Netherlands	0.7	-0.6	-0.5	-3.8	-3.5	-3.0
Portugal	-3.7	-2.8	-2.6	-4.9	-5.9	-6.6
Spain	1.9	1.6	-3.5	-6.8	-4.9	-4.2
<u>Euro area</u>	<u>-1.8</u>	<u>-1.5</u>	<u>-2.3</u>	<u>-3.8</u>	<u>-4.4</u>	<u>-4.3</u>

Source: OECD

The emergence of a structural deficit means that at given rates of taxation and expenditures the economy will continue to experience a government deficit when activity returns to its

potential or full employment output level. This implies a decline in the long run or equilibrium rate of economic activity and a rise in the 'natural' rate of unemployment defined as unemployment which is due to structural rather than cyclical factors.

Put another way a move from structural balance or surplus to a structural deficit suggests a *permanent* fall in potential output and an increase in structural or long-term unemployment. For example in Ireland, Bergin et. al. (2010), estimate that fiscal consolidation in the form of higher a tax burden and cuts in public sector pay, combined with effects of the global downturn, the financial crisis and the collapse of the construction sector could have reduced potential output by at least 15 percent of GDP.

Given that the majority of euro area economies are currently subject to an EDP it would be difficult to argue that the SGP has been a success. While there are cases in which excessive deficits may be largely attributed to the recent financial crisis and global downturn there are others such as Greece, Ireland and Spain where domestic factors have played a significant role. Also the emergence of structural deficits implies that cyclical factors alone cannot fully account for the current deterioration in the euro area's public finances. As Willem Buiter (2003) noted:

"The problem with the pactthat appears to be evolving – one violation at a time – is that there continues to be insufficient flexibility but there now also is too much scope for opportunistic, politically motivated manipulation of the framework and the process."

The following section considers weaknesses in the SGP and analyses possible reforms which if implemented might lead to greater fiscal stability in the euro area.

4. Reforming the Pact

Ever since the inception of the SGP economists and commentators have pointed to perceived weakness and suggested a long list of reforms designed to strengthen its effectiveness and deliver fiscal consolidation to the euro area. This section outlines the Pact's major flaws and assesses possible reforms.

Criticisms of the SGP

Criticisms of the SGP can be grouped under four headings, enforcement and surveillance, inflexibility, asymmetry *and its impact on public investment and economic growth*.

Enforcement and surveillance: Enforcing the rules of the SGP has been an issue since the Pact commenced in 1999. Not only did the Council fail to enforce the full weight of the EDP against France and Germany in 2003 but between 2002 and 2006, years of moderate to good economic growth, five Member States (France, Germany, Greece, Italy and Portugal) had deficits consistently above or very close to the 3 percent threshold but sanctions were not imposed in any case. Indeed as of 2010 full sanctions, or what Herman Van Rompuy President of the European Council has called "the nuclear option" in the form of deposits and fines have not been enforced against any country.²

Also, for most of the life of the SGP there has been close to zero compliance with the CBS rule which is essential to ensure that fiscal policy can operate counter-cyclically without breaching the 3 percent reference value. The former suggests a failure of the Pact's corrective arm while the latter suggests weak surveillance and monitoring under the preventive arm. Arguably the poor track record of surveillance and enforcement is a consequence of the Pact's self-regulating nature. That is, while the Commission can make recommends the final decisions on triggering the EDP, the timeline for corrective action and the ultimate imposition of sanctions are made by the members of the ECOFIN Council which consists of elected politicians who must consider national and political priorities in addition to economic objectives. In short the SGP is self-regulating in the sense that key decisions are made by those whose policy decisions are in many cases the prime cause of excessive deficits and who have the responsibility for taking the necessary but often domestically unpopular corrective actions.

² European Council press release 7 June 2010.

Inflexibility: The SGP has also been criticised on the grounds that it lacks flexibility in that it focuses on the actual deficit without consideration of the underlying circumstances and differences between Member States. There are several aspects to this type of criticism.

First, the Pact does not control for the fact that different Member States may be in different phases of their business cycles and therefore require different fiscal strategies. For example, in the case of Germany the onset of recession together with the continuing costs of reunification were important reasons underlying the rise in the deficit in 2002 and 2003 and the enforcement of corrective measures such as increased taxation and expenditure cuts would have rendered fiscal policy pro-cyclical leading to a deeper and more prolonged recession. By contrast other national economies such as Ireland and Spain were experiencing a sustained period of strong economic growth requiring different fiscal constraints and medium term strategies.

Second, although some discretion is permitted under the 2005 reforms the Pact still applies the 3 percent reference value uniformly across the euro area without due reference to outstanding debt. However, an excessive deficit of 1 or 2 percent has very different implications for a country with a high and rising debt ratio than it has for a country with a low and stable debt ratio.

Third, when setting fiscal targets the Pact ignores the fact that countries differ in terms of real convergence. Differences in real per capita incomes, infrastructural requirements, population age structures and future pension provisions imply that euro area economies may require different medium to long-term fiscal strategies.

Asymmetry: The SGP is asymmetric in that it penalises countries for running excessive deficits during recessions but provides few incentives for enhanced fiscal consolidation during periods of high and rapid growth. (Monperrus-Veroni and Saraceno 2005). It is true that the CBS rule requires countries to run a balanced budget or a surplus when times are good but as has been shown it has not been enforced and it does not reward compliant countries by granting greater flexibility when hit by an adverse shock.

Also, the effectiveness of fiscal policy as a means to stabilising cyclical fluctuations in economic activity differs markedly across euro area countries. In small and very open economies such as Ireland, Belgium etc. a high propensity to import means that fiscal multipliers are low with the implication that counter-cyclical policies are ineffective relative to their impact in larger economies such as Germany and France. Hence while there can be

no convincing argument in favour of pro-cyclical policies full compliance with the CBS rule, which permits policy to operate counter-cyclically, is less rewarding to small countries in which discretionary fiscal policies have a relatively small impact on economic activity.

Public Investment and Economic Growth: While the 2005 reforms allow for ‘other relevant factors’ such as expenditure on research and development to be taken into account when assessing budgetary positions compliance with the CBS rule still implies that expenditures on capital projects which may improve the economy’s productive capacity must be financed from current revenues raised from taxation on the current generation with the consequence that the SGP may act as a disincentive to undertake public investment projects to the detriment of future generations.

Two additional points are important here. First, the Pact focuses on current government expenditures and tax revenues as the principal means of controlling deficit and debt ratios. However, to the extent that public investment and tax incentives designed to enhance the economy’s productive capacity lead to an increase in the growth rate of real GDP they can, other things being equal, also lead to a reduction in deficit and debt ratios. Second, borrowing to finance projects which increase productive capacity and economic growth can also reduce the structural deficit via a compensating increase in potential output and a decline in the natural rate of unemployment which, in turn, implies higher government revenues and lower expenditures.

Reforms

Proposed changes to the SGP can be classified under three headings, institutional and procedural reforms, the quality of public finances and greater focus on the debt criterion.

Institutional and Procedural Reforms

Faced with a growing fiscal crisis in the euro area, the European Council has now established a Task Force on Economic Governance with the objective of “strengthening budgetary discipline through the Stability Pact”. Although this group’s work is on-going European Council Conclusions of 17 June 2010 suggest several institutional changes designed to strengthen enforcement and surveillance procedures. First, the Council proposes to strengthen existing procedures by introducing an annual “European semester”. That is, a period early in each year when national budgetary plans would be broadly assessed by the

Commission and the ECOFIN Council with particular reference to projections for economic growth, inflation, government revenues and spending. Second, the Council Conclusions suggest an increase focus on debt developments. This could mean the EDP being activated if the debt to GDP ratio is above 60 percent but not declining at a satisfactory rate.

Significantly, these plans focus heavily on strengthening the role of sanctions. The current Economics Commissioner Olli Rehn has proposed stronger penalties for Member States that breach Stability and Growth Pact objectives. He has proposed the suspension of a portion of EU funding if deficit targets are missed. A further plan would be for governments to be required to make interest-bearing deposits with the European Commission if their budget plans do not deliver agreed targets.

This approach has received strong endorsement from the Commission President José Manuel Barroso. He has also argued for tougher budgetary rules. Speaking to the European Parliament he stated that:

“What is at stake is the future of the euro and you could say to some extent the future of our European project.”

(Irish Times, July 7th, 2010)

At first sight these plans appear to be a limited and flawed form of peer review. Limited because as yet it lacks any enforcement mechanism and flawed because it retains the self-regulating nature of the SGP. An alternative is for each country to appoint an *independent* National Fiscal Council (NFC) consisting of qualified experts in public finance and macroeconomics. This proposal comes in a variety of forms differentiated by the responsibilities which would be assigned to the NFC. As initially suggested by Wyplosz (2005) decisions on the size of the deficit target would be taken from government and given to the NFC whereas Sapir (2004) and Annett *et. al.* (2005) suggest that the role of the NFC should be restricted to assessing the government’s budgetary targets and monitoring policies put in place to achieve them. Given that governments are very unlikely to delegate decisions on tax and expenditure plans to a non-elected group of experts the latter approach is undoubtedly the more feasible.

It is of interest to note that the UK government has moved along this second route by establishing the Office for Budget Responsibility (OBR) which will assess government tax and spending proposals and make independent forecasts for economic growth and budgetary outcomes. This initiative appears to have several important advantages. First, it leaves

decisions on budgetary targets in the hands of elected politicians. Second, the success of country Stability Programmes are largely dependent on accurate forecasts for growth and inflation. When these are left to finance ministers and their departments there is an obvious tendency to make over optimistic forecasts for growth which in turn implies over optimistic forecasts for government revenues and expenditures. Transferring this responsibility to an independent body “depoliticises” economic forecasting leading to the possibility of more accurate outcomes. Thirdly, as it does not require prior approval from the Commission or the Council there is nothing to prevent any euro area country taking a similar initiative and establish a similar body.

At the European level there is also a case for establishing an equally independent EU fiscal authority, possibly within the Commission and similar in design to the ECB’s Executive Board, to which the NFCs would report. Whereas the country specific NFC would make an assessment on whether the national government’s plans are consistent with its commitments under the SGP and its agreed Stability Programme the supranational body would take an EU wide approach in assessing the aggregate implications of individual country plans and if necessary make recommendations to the Council which would retain the power to impose sanctions when deemed necessary. While this proposal does not completely remove the self-regulatory nature of the SGP it could lead to significant improvements in surveillance, which would be transferred to the national level, and enforcement in that finance ministers would be required to bring recommendations from their national council of experts to the Council. However its success would largely depend on the manner in which the NFC is appointed with total transparency and absolute guarantees on expertise and independence being necessary conditions.

The Quality of Public Finances

One of the most commonly discussed changes to the SGP is the so called *golden rule* proposal which requires that the overall budget be split into two components, a current account and a capital account (Blanchard and Giavazzi 2003). Under the golden rule the current budget should be kept in balance over the course of the business cycle and borrowing should be permitted only to finance productive investment.

This differs from the CBS rule which requires that the overall budget be kept in balance and does not distinguish between current and capital expenditures. The claimed advantages of

the golden rule is that it eliminates possible bias against public investment, improves the economy's productive capacity, addresses the problems faced by countries with outstanding 'infrastructural deficits' and shifts the burden of borrowing to finance long-lived projects to future generations. Unfortunately most of the available evidence suggests that these claimed advantages may be tenuous. First, as shown by Monperrus-Veroni and Saraceno (2005) there is little evidence to suggest that fiscal consolidation under the SGP has had a detrimental impact on public investment in the euro area. Second, there are no guarantees that public investment always results in significant growth effects and may in fact be subject to rapidly decreasing diminishing returns (De la Fuente, 1997 and Buti *et. Al*, 2005). Third the classification of expenditures into current and capital items is fraught with difficulty. For example, current expenditures on education and health increase the stock of human capital which is a key driver in increasing labour productivity. Would salaries paid to educational and health care workers be treated as current or capital expenditures? Fourth, why is it necessarily more efficient to endow future generations with a higher stock of public capital rather than a lower stock of liabilities? Fifth, why should borrowing to finance public capital be preferred to tax initiatives designed to stimulate private sector investment as a means of improving productive capacity? Finally, the EU budget and the use of structural and cohesion funds may be an equally if not more efficient way to address the disparity in real economic convergence among euro area countries.

The Debt Criterion

Clamfors and Corsetti (2003), the Economic Advisory Group (2003) and Monperrus-Veroni and Saraceno (2005) have all proposed modifications to the SGP which would let the threshold value for the deficit vary inversely with the debt ratio so that countries with low debt-to-GDP ratios can be permitted higher deficits and vice-versa. Perhaps the most straightforward and operationally simple of these proposals is that of Monperrus-Veroni and Saraceno (2005) who suggest weighting the 3 percent threshold by "relative debt" defined as the ratio of the 60 percent Maastricht reference value to the country's actual debt ratio. Under this proposal a country with a debt-to-GDP ratio of, say, 40 percent would be

permitted a maximum deficit ratio of 4.5 percent whereas a country with an 80 percent debt ratio would be required to satisfy a 2.25 percent deficit target.³

Table 4 Projected and Weighted Deficit Ratios (% of GDP)

Ireland and Spain 2009 – 2014						
	2009	2010	2011	2012	2013	2014
Ireland						
Real GDP(% Change)	-7.5	-1.3	3.3	4.5	4.3	4.0
Projected Debt Ratio	64.5	77.9	82.9	83.9	83.3	80.8
Projected Deficit Ratio	-11.7	-11.6	-10.0	-7.2	-4.9	-2.9
Weighted Deficit Ratio	-2.8	-2.3	-2.2	-2.1	-2.2	-2.2
Spain						
Real GDP(% Change)	-3.5	-0.3	1.8	2.9	3.1	
Projected Debt Ratio	55.2	65.9	71.9	74.3	74.1	
Projected Deficit Ratio	-11.4	-9.8	-7.5	-5.3	-3.0	
Weighted Deficit Ratio	-4.5	-3.3	-2.7	-2.5	-2.4	

Source: European Commission (2010) *Updated Stability Programmes for Ireland and Spain*.

While this proposal addresses the asymmetric nature of the SGP by providing incentives for fiscal consolidation and debt reduction during the upswing of the business cycle it is limited in that it can impose unrealistic constraints on countries experiencing rising debt ratios caused by a severe economic downturn. This effect is illustrated by Table 4 which uses Irish and Spanish projections for 2009 to 2014 to compare the deficit ratios agreed under the Stability Programmes for each country together with estimates of the weighted or relative deficit as proposed by Monperrus-Veroni and Saraceno. It is clear from the estimates in Table 4 that application of the Monperrus-Veroni and Saraceno proposal would have required Ireland and Spain to initiate extreme fiscal contractions in the face of a severe

³ The permitted deficit is computed as $(60/DR_{t-1})$ times 3 where DR_{t-1} is the actual debt-to-GDP ratio in the previous year.

economic downturn implying tax increases and expenditure cuts on an unprecedented and politically impossible scale. The reason is, of course, that the combined effects of recession and financial crisis have led to rapidly increasing debt ratios in both countries with the Irish ratio increasing from 25 to 64 percent between 2007 and 2009 and the Spanish from 36 to 55 percent.

Further, strict application of this rule would unduly penalise countries with historically high debt ratios but who have also complied with the SGP by keeping their deficits under the 3 percent threshold. For example, over 1999 to 2008 the Italian deficit ratio averaged 2.7 percent of GDP which is broadly compliant with the requirements of the SGP. However, over the same period Italy also recorded an average annual debt-to-GDP ratio of 107 percent which under the Monperrus-Veroni and Saraceno rule gives an average weighted deficit target of 1.7 percent.

We should not, however, conclude that this type of proposal has little merit and should be rejected out-of-hand. On the contrary it could prove to be a useful addition to the SGP when conditions return to 'normality' with European economies operating at close to their full employment output levels. Under these conditions the proposal gives a strong incentive to operate an effective counter-cyclical policy by running surpluses and reducing debt ratios in the 'boom' years with the reward of greater flexibility during the downswing. Also there is a case for applying the rule asymmetrically by maintaining the 3 percent reference value for high debt countries but giving greater flexibility to countries that have successfully reduced and maintained their deficits below the 60 percent threshold.

5. Conclusions and Recommendations

Conclusions

A stability pact that delivers fiscal coordination and consolidation of public finances is essential to the success of monetary union with the recent experience of Greece, and to a lesser extent Ireland and Spain, clearly demonstrating that fiscal ill discipline in even small to medium sized economies can be highly destabilising and costly to the monetary union as a whole. Maintaining fiscal discipline also benefits individual economies. Member States that comply with the rules can run fiscal policy in a counter-cyclical manner and have greater scope for growth enhancing initiatives. However those which run lax fiscal policies and do not balance their budget over the course of the business cycle may often find themselves having to initiate fiscal retrenchment when growth slows and the economy starts to contract.

Even before the recent global downturn and financial crisis it was clear that the Europe's Stability and Growth Pact was not delivering these benefits and that there was a clear case for reform. The continued breaching of the SGP and the lack of credible sanction against any 'breaching' Member State had seriously eroded the credibility of the Pact.

The current European economic crisis makes it very likely that the Pact will be reformed by the end of this year. The establishment of the European Stabilisation Fund, the cost of the Greek support plan and the rising domestic political concern amongst fiscally strong nations (specifically Germany) make it very likely that the Pact will be changed by the European Council by the end of this year.

A more credible SGP will have a significant effect on the conduct of economic policy within small open economies such as Ireland. This will be through the creation of firmer parameters within which fiscal decisions will be made. A more credible pact will also require greater inspection of the domestic budgetary assumptions and forecasts.

Ireland should not fear a reformed pact. The emergence of a substantial current borrowing requirement and the development of a structural budget deficit are posing massive challenges to our country. Any process which reduces the possibility of this happening again in the future should be embraced.

However the proposals published recently by the European Commission and under active consideration by the European Council's Task Force on Economic Governance which aim to reform the Pact have serious omissions that must be addressed. These omissions can be summed up as the need for more 'carrot' as well as a more effective 'stick'. More focus must be put on effective national surveillance of budgets, more flexibility on national debt levels and more sustained focus on underlying levels of economic growth to address structural budget deficits. These are addressed in the below recommendations.

Effective reform does not necessarily imply radical changes in the Pact's core objectives or in the tools available to achieve these objectives. In particular there is no convincing case for serious modification of the 'close to balance or in surplus' rule or for eroding the Commission and Council's authority in issuing early warnings, making recommendations for corrective actions and ultimately imposing sanctions on non-compliant countries.

Recommendations

To improve surveillance procedures, national governments should establish National Fiscal Councils charged with the role of assessing budgetary policies and providing independent forecasts for economic growth and government revenues and expenditures. These steps should firstly be taken at national level. The United Kingdom has recently taken this initiative with the establishment of the Office for Budget Responsibility and similar functions are preformed by the Central Planning Bureau in the Netherlands and the Federal Planning Bureau in Belgium. Hence there is nothing to prevent other countries such Ireland doing the same. The advantage is that providing these councils are permitted to operate in a truly independent manner they can strengthen both surveillance, which would be transferred to the national level, and enforcement with finance ministers less likely to press for exceptions and compromises if they are required to bring recommendations from their national council of experts to ECOFIN. However we again stress its success would largely depend on the manner in which the national council is appointed with total transparency and absolute guarantees on expertise and independence being necessary conditions.

The new pact must recognise overall levels of national debt and display flexibility for economies with more sustainable debt levels. A 'one size fits all' debt rule does not recognise sustained levels of responsible debt management. To date the 60 percent debt criterion has played only a minor role in the operation of the SGP. However initial work of

the Council's Task Force on Economic Governance suggests that the debt criterion might be used as an early trigger for the EDP which could be activated if the debt to GDP ratio is above 60 percent and not declining at a satisfactory rate (Press Release 7 June 2010).

While this proposal would penalise Member States whose lax fiscal policies, especially in years of high economic growth, have led to rising debt ratios and sustainability problems it may also prove insufficient in that it relies on "too much stick and not enough carrot". In addition to penalising fiscal profligacy a firmer application of the debt criterion should also reward countries that have taken the advantage of high growth to reduce their deficits. As discussed above this reward could come in terms of higher deficit threshold values for countries whose debt ratio has been consistently maintained below the 60 percent benchmark.

The reformed pact should track the development of structural budget deficits and make more allowances for growth promoting policies that can lead to a reduction in structural deficit levels. As this report has emphasised the emergence of structural deficits across the euro area is perhaps the most disturbing aspect of the recent economic downturn. As the structural deficit 'cleans' out cyclical movements it provides a measure of what the actual deficit would be if the economy were to return to its potential or full employment output level. A move from structural balance or surplus to deficit most likely reflects a permanent decline in potential output and a corresponding increase in structural or long-term unemployment.

Structural deficits can be reduced in two ways. First, governments can bring the budget into balance at potential output by increasing taxation and/or cutting expenditures. This is in fact what would be required by the Pact's CBS rule. Second, a structural imbalance can be removed by policies which promote faster growth to offset the decline in potential output. Such policies would normally focus on increasing labour productivity by encouraging technological change and innovation through research and development strategies etc. When setting deficit targets allowances could be made for expenditures on growth promoting policies. This is to some extent included in the 'other relevant factors' of the 2005 reforms but is difficult to quantify and remains imprecise and open to interpretation.

This situation might be improved if when presenting their annual budgets and Stability Programmes governments were to explicitly identify which items are intended to promote growth and explain how this objective will be achieved. For example, explain how proposals

for additional expenditure on transport infrastructure or third level academic research will result in an eventual increase in productivity and the economy's potential growth rate. These proposals and analysis could then be assessed by the countries National Fiscal Council whose findings would be made public and available to the Commission and ECOFIN.

Measures of 'real economic performance' such as productivity, competitiveness and labour market policies must be included in a reformed pact. This is essential. Failure to meet agreed targets in these areas should not trigger sanctions. However, it would be hoped that their regular review at European Council and ECOFIN meetings would provide a greater focus on these facets of economic performance that are as important as debt targets. It must be emphasised that sustained periods of economic growth provides the best tools for debt reduction. The policy areas that stimulate growth should, therefore, be worthy of regular high level review.

Appendix A: References

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Appendix B: Membership of the Joint Committee

Updated 5 July 2010

Deputies:

Pat Breen	(FG)
Thomas Byrne	(FF) ⁴
Brendan Howlin	(Lab) ⁵
Lucinda Creighton	(FG)
Timmy Dooley	(FF) Vice-Chairman
Bernard Durkan	(FG) Chairman
Beverley Flynn	(FF)**
Seán Power	(FF) ⁶
Michael Mulcahy	(FF)
Mary O'Rourke	(FF)
Séan Barrett	(FG) ⁷
Noel Treacy	(FF)
Joanna Tuffy	(Lab)**

⁴ Deputy Thomas Byrne (FF) replaced Deputy Barry Andrews (FF) (on appointment as Minister of State at the Department of Health and Children), by Order of Dail Eireann on 26th June 2008

⁵ Deputy Brendan Howlin (Lab) replaced Deputy Joe Costello (Lab) by Order of Dáil Éireann on 8th July 2010.

⁶ Deputy Sean Power (FF) replaced Deputy Michael McGrath (FF) by Order of Dáil Eireann 10th July 2009

⁷ Deputy Seán Barrett (FG) replaced Deputy Billy Timmins (FG) by Order of Dáil Éireann on 8th July 2010.

Senators:	Maurice Cummins	(FG)*
	Mark Deary	(GP)* ⁸
	Pearse Doherty	(SF)*
	Paschal Donohoe	(FG) ⁹
	John Hanafin	(FF)
	Terry Leyden	(FF)
	Rónán Mullen	(Ind)*
	Phil Prendergast	(Lab)
	Feargal Quinn	(Ind)

⁸ Senator Deirdre deBurca resigned as of 16 February 2010. Replaced by Senator Mark Dearey on 22 June 2010.

⁹ Senator Paschal Donohoe (FG) replaced Senator Maurice Cummins (FG) by way of report laid before Seanad Eireann by the Committee on Selection on 5th December 2007

*by way of report laid before Seanad Eireann by the Committee on Selection on 7 October 2008

** Members appointed to the Committee by Order of Dail Eireann 2 October 2008

Appendix C: Orders of Reference of the Joint Committee

Dáil Éireann on 23 October 2007 ordered:

- “(1) (a) That a Select Committee, which shall be called the Select Committee on European Affairs, consisting of 11 Members of Dáil Éireann (of whom four shall constitute a quorum), be appointed to consider—
- (i) such Bills the statute law in respect of which is dealt with by the Department of Foreign Affairs;
 - (ii) such proposals contained in any motion, including any motion within the meaning of Standing Order 159 concerning the approval by the Dáil of international agreements involving a charge on public funds; and
 - (iii) such other matters
- as shall be referred to it by Dáil Éireann from time to time.
- (b) For the purpose of its consideration of matters under paragraphs (1)(a)(i), (ii) and (iii), the Select Committee shall have the powers defined in Standing Order 83(1), (2) and (3).
- (c) For the avoidance of doubt, by virtue of his or her *ex officio* membership of the Select Committee in accordance with Standing Order 92(1), the Minister for Foreign Affairs (or a Minister or Minister of State nominated in his or her stead) shall be entitled to vote.
- (2) (a) The Select Committee shall be joined with a Select Committee to be appointed by Seanad Éireann to form the Joint Committee on European Affairs to—
- (i) consider such matters arising from Ireland’s membership of the European Communities and its adherence to the Treaty on European Union, as it may select;
 - (ii) consider such—

- (I) programmes and guidelines prepared by the Commission of the European Communities as a basis for possible legislative action,
- (II) non legislative documents published by any Union Institution in relation to EU policy matters,
- (III) acts of the institutions of the European Communities,
- (IV) regulations under the European Communities Acts 1972 to 2007,
- (V) other instruments made under statute and necessitated by the obligations of membership of the European Communities, and
- (VI) any other document relating to European Union matters deposited in both Houses of the Oireachtas by a Member of the Government or Minister of State,

as it may select;

- (iii) consider such other matters as may be referred to it from time to time by both Houses of the Oireachtas; and
- (iv) represent both Houses of the Oireachtas at the Conference of Community and European Affairs Committees of Parliaments of the European Union (COSAC) jointly with the Joint Committee on European Scrutiny;

and shall report thereon to both Houses of the Oireachtas in consultation with the Joint Committee on European Scrutiny.

(b) The Joint Committee shall have:

- (i) the powers defined in Standing Order 83(1) to (9) inclusive;
- (ii) the power to refer a proposal for EU legislation which has been considered by it (and which has been concluded to be of sufficient importance to require additional scrutiny) to a Joint Committee on which has been conferred the power defined in Standing Order 83(4) to

consider such proposals;

- (iii) the power to request the attendance of Members of the Government (or Ministers of State nominated in their stead) (or, in the case of the European Council, the Taoiseach or Minister for Foreign Affairs) before the Joint Committee and provide, in private session if so desired by the Member of the Government or Minister of State, oral briefings in advance of Council meetings to enable the Joint Committee to make known its views; and
 - (iv) the power to make recommendations to the Minister for Foreign Affairs (or Minister of State) on European Union matters.
- (c) The following persons may attend meetings of the Joint Committee and may take part in proceedings without having a right to vote or to move motions and amendments—
- (i) Members of the European Parliament elected from constituencies in Ireland (including Northern Ireland);
 - (ii) members of the Irish delegation to the Parliamentary Assembly of the Council of Europe; and
 - (iii) at the invitation of the Joint Committee, other Members of the European Parliament.
- (d) The quorum of the Joint Committee shall be five, of whom at least one shall be a Member of Dáil Éireann and one a Member of Seanad Éireann.
- (3) The Chairman of the Joint Committee, who shall be a Member of Dáil Éireann, shall also be Chairman of the Select Committee.”.

Dáil Éireann on 2 October 2008 ordered:

That the Orders of Reference of the Select Committee on European Affairs be amended in paragraph (1)(a) by the deletion of ‘11 members’ and the substitution therefor of ‘13 members’.

Seanad Éireann on 24 October 2007 ordered:

“(1) (a) That a Select Committee consisting of 6 members of Seanad Éireann shall be appointed to be joined with a Select Committee of Dáil Éireann to form the Joint Committee on European Affairs to—

(i) consider such matters arising from Ireland’s membership of the European Communities and its adherence to the Treaty on European Union, as it may select;

(ii) consider such—

(I) programmes and guidelines prepared by the Commission of the European Communities as a basis for possible legislative action,

(II) non legislative documents published by any Union Institution in relation to EU policy matters,

(III) acts of the institutions of the European Communities,

(IV) regulations under the European Communities Acts 1972 to 2007,

(V) other instruments made under statute and necessitated by the obligations of membership of the European Communities,

and

(VI) any other document relating to European Union matters deposited in both Houses of the Oireachtas by a Member of the Government or Minister of State,

as it may select;

(iii) consider such other matters as may be referred to it from time to time by both Houses of the Oireachtas; and

(iv) represent both Houses of the Oireachtas at the Conference of Community and European Affairs Committees of Parliaments of the

European Union (COSAC) jointly with the Joint Committee on European Scrutiny;

and shall report thereon to both Houses of the Oireachtas in consultation with the Joint Committee on European Scrutiny.

- (b) The Joint Committee shall have:
- (i) the powers defined in Standing Order 70(1) to (9) inclusive;
 - (ii) the power to refer a proposal for EU legislation which has been considered by it (and which has been concluded to be of sufficient importance to require additional scrutiny) to a Joint Committee on which has been conferred the power defined in Standing Order 70(4) to consider such proposals;
 - (iii) the power to request the attendance of Members of the Government (or Ministers of State nominated in their stead) (or, in the case of the European Council, the Taoiseach or Minister for Foreign Affairs) before the Joint Committee and provide, in private session if so desired by the Member of the Government or Minister of State, oral briefings in advance of Council meetings to enable the Joint Committee to make known its views; and
 - (iv) the power to make recommendations to the Minister for Foreign Affairs (or Minister of State) on European Union matters.
- (c) The following persons may attend meetings of the Joint Committee and may take part in proceedings without having a right to vote or to move motions and amendments—
- (i) Members of the European Parliament elected from constituencies in Ireland (including Northern Ireland);
 - (ii) members of the Irish delegation to the Parliamentary Assembly of the Council of Europe; and
 - (iii) at the invitation of the Joint Committee, other Members of the European Parliament.

(d) The quorum of the Joint Committee shall be five, of whom at least one shall be a Member of Dáil Éireann and one a Member of Seanad Éireann.

(2) The Chairman of the Joint Committee, shall be a Member of Dáil Éireann.”.

Seanad Éireann on 7 October 2008 ordered:

That the Orders of Reference of the Select Committee on European Affairs be amended in paragraph (1)(a) by the deletion of ‘6 members’ and the substitution therefor of ‘9 members’.