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European Fiscal Policies Under the Stability Pact — Some First Insights

by

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Abstract:
EU Member countries have shown different degrees of ambition to reach a budget position of "close to balance or in surplus". Differences in ambition can only partly be explained by the relative size of cyclical safety margins or differences in the number of votes in the ECOFIN Council. It is also shown that in the medium run there is no evidence for a trade-off between budget consolidation and growth. Of the eight countries with the strongest reduction of structural budget deficits in the period 1992-2001, only one showed growth rates below the EU average. The other seven countries even managed to achieve higher growth rates than in the period 1974-91 during which structural deficits had increased.

Keywords : Fiscal Policy, Budget Deficits, European Union

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1 Introduction

The Stability and Growth Pact which was finalised in summer 1997 established a strict framework for fiscal policies in the member countries of the euro area. The main purpose of the Pact was to reduce risks for the stability of the new European currency that could result from possible inflationary debt-bailouts (Siebert 1997; Eichengreen and Wyplosz 1998). While the Maastricht-Treaty contains a no-bailout clause, it was questioned whether the ECB could in effect just stand aside if a member country, or several member countries, became insolvent.

The Stability and Growth Pact consists of three elements: a resolution of the European Council at the Amsterdam meeting of June 17, 1997, and two ECOFIN Council Regulations of July 7, 1997[1]. The Pact embodies two functions. First, a dissuasive function. The Pact goes beyond the Maastricht Treaty by clarifying and speeding up the excessive deficit procedure. It states, in particular, that a deficit of more than 3 per cent of GDP cannot be attributed to exceptional circumstances if recessions involve a fall of real GDP by less than 0.75 per cent. Moreover, the Pact explicitly specifies the scale of sanctions in the event of persistent excessive deficits (European Commission 2000, p. 48).

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[1] The political initiative for the Stability Pact came from the German Finance Minister Theo Waigel, who made a proposal to the EU Ministers of Finance in his letter of November 10, 1995 (Cabral 1999, p. 20). It relied in major parts on a suggestion that had been made in a discussion paper of the Kiel Institute (Lehment and Scheide 1995).

Up to now, no member country of the Euro area has been judged to have an excessive deficit, which means that the dissuasive element has not yet been applied. Second, the Pact has a preventive function. To avoid the occurrence of excessive deficits, each member of the Euro area has to submit a stability programme (other EU-members submit a convergence programme). It includes information about the medium-term objective for the budget position, which has to be close to balance or in surplus, and about the adjustment path towards the target. The programmes are updated on an annual basis and monitored by the European Council and the European Commission.

In this paper, we shall take a closer look at budgetary balances in the EU-countries before and after the start of EMU (Part 2). We shall, then, address the question why some countries have so far not succeeded in attaining the medium-run budget objectives; in this context, we shall also deal with the issue of whether there is a trade-off between deficit reduction and growth (Part 3). Finally, we point out some lessons that can be drawn from the operation of the Stability and Growth Pact in the first years (Part 4).

2 EU – Financial Balances Before and After the Start of EMU

When EMU took off on January 1, 1999 and the Stability and Growth Pact entered fully into force[2], the member countries of the Euro area could look back to a substantial reduction of the cumulative government deficit from 5.1 per cent of GDP in 1992 (the first year after the signing of the Maastricht Treaty) to 2.2 per cent of GDP in 1998 (Table 1). There were, however, also substantial differences among the countries. In Belgium, Finland and Italy the average annual deficit reduction was far above the mean Euro-area rate of 0.5 percentage points. The same holds for Greece, which joined the Euro area in 2001. In contrast, France, Germany, Portugal and Spain only achieved a small deficit reduction as compared to 1992; Austria even recorded a slight increase of the deficit which, however, still remained below the 3 per cent threshold. These differences to some degree may be explained by the different starting positions, i.e. countries with a relatively high deficit ratio in 1992 reduced their deficits most strongly. While the fiscal convergence criteria of the Maastricht Treaty have been conducive to deficit reduction in these countries, it should be noted that substantial deficit reductions also occurred in the EU-countries which have chosen not to join the Euro area. In fact, the average decline of the deficit ratio in these countries was above that for the Euro area in the period 1992-98; Den-

[2] The surveillance part of the Pact already went into force on July 1, 1998.

mark, Sweden and the UK all managed to move from a substantial deficit position in 1992 to a surplus in 1998.

Table 1: General Government Financial Balances in the EU 1992-2001[a]

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001[b]	Annual Average Change	
											1992-1998	1998-2001
Austria	-2.0	-4.2	-5.0	-5.2	-3.8	-1.9	-2.4	-2.2	-1.1	0.0	-0.1	0.8
Belgium	-7.9	-7.3	-5.0	-4.4	-3.7	-2.0	-0.8	-0.6	0.1	0.0	1.2	0.3
Denmark	-2.2	-2.9	-2.4	-2.3	-1.0	0.4	1.1	3.1	2.8	2.0	0.6	0.3
Finland	-5.6	-7.3	-5.7	-3.7	-3.2	-1.5	1.3	1.9	6.9	3.7	1.2	0.8
France	-4.2	-6.0	-5.5	-5.5	-4.1	-3.0	-2.7	-1.6	-1.4	-1.5	0.3	0.4
Germany	-2.5	-3.1	-2.4	-3.3	-3.4	-2.7	-2.2	-1.6	1.2	-2.5	0.1	0.1
Greece	-12.6	-13.6	-9.9	-10.2	-7.4	-4.0	-2.4	-1.8	-1.1	0.2	1.7	0.9
Ireland	-3.9	-2.7	-2.0	-2.2	-0.2	1.2	2.3	2.3	4.6	3.2	0.9	0.3
Italy	-10.7	-10.3	-9.3	-7.6	-7.1	-2.7	-2.8	-1.8	-0.3	-1.4	1.3	0.5
Luxembourg	0.7	2.1	2.9	2.3	2.0	3.4	3.4	3.6	6.1	5.3	0.5	0.6
Netherlands	-4.4	-3.6	-4.2	-4.2	-1.8	-1.1	-0.8	0.4	2.2	1.1	0.6	0.6
Portugal	-2.9	-6.0	-5.9	-4.6	-4.0	-2.7	-2.3	-2.1	-1.5	-1.7	0.1	0.2
Spain	-4.0	-6.7	-6.1	-6.6	-4.9	-3.2	-2.6	-1.2	-0.3	0.0	0.2	0.9
Sweden	-7.8	-11.9	-10.8	-7.7	-3.1	-1.6	2.1	1.7	4.1	3.8	1.7	0.6
U. K.	-6.4	-7.9	-6.7	-5.8	-4.4	-2.2	0.4	1.1	1.9	1.1	1.0	0.2
Euro area	-5.1	-5.8	-5.1	-5.0	-4.3	-2.6	-2.2	-1.3	0.2	-1.2	0.5	0.3
European Union	-5.4	-6.4	-5.6	-5.3	-4.3	-2.5	-1.7	-0.8	0.6	-0.7	0.6	0.3

[a]Surplus (+) or deficit(-) as percentage of nominal GDP. [b]OECD estimate.

Source: OECD (2001), own calculations.

Looking at the first three years after the start of EMU one finds that the cumulative deficit in the Euro area has continued to fall, although at a somewhat lesser pace than in the preceding period. In 2001 the cumulative deficit amounted to about 1.2 per cent of GDP. On a country by country basis, there are eight countries in 2001 with a budget position that is in surplus or in balance (Austria, Belgium, Finland, Greece, Ireland, Luxembourg, Netherlands and Spain), whereas four countries (France, Germany, Italy and Portugal) still had deficit ratios above 1 per cent and in the case of Germany even above 2 per cent. The three EU-countries that are not members of the Euro area show budget surpluses in 2001 which are higher than in 1998.

In order to assess to which extent the reduction in budget deficits can be considered as a structural rather than a cyclical phenomenon, OECD-estimates of structural government balances are presented in Table 2. For the period 1992-1998 the figures in Table 2 largely correspond to those in Table 1. They show that the strong reduction of the deficits in Belgium, Greece, Italy and Sweden can be largely ascribed to a substantial cut in the structural budget deficit. In contrast, the improvement of the Finnish budget is dominated by the upswing from the deep recession in the early nineties, while structural budget cuts only played a minor role. Table 2 also shows that reductions in the Euro area's cumulative structural budget deficits have become smaller since 1999. This can be explained by the fact that budget deficits in all EU-countries had already fallen

Table 2: General Government Structural Balances in the EU 1992-2001[a]

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001[b]	Annual Average Change	
											1992-1998	1998-2001
Austria	-2.7	-4.1	-4.9	-4.9	-3.6	-1.6	-2.5	-2.4	-1.9	0,0	0.0	0.8
Belgium	-9.9	-6.8	-4.5	-4.0	-2.6	-1.6	-0.4	-0.5	-0.7	-0.2	1.6	0.0
Denmark	1.0	1.8	-0.1	-0.5	0.3	0.9	1.2	3.2	2.4	2.2	0.0	0.3
Finland	0.6	0.8	0.8	1.0	0.5	0.1	1.8	2.1	5.6	4.0	0.2	0.7
France	-4.2	-5.0	-4.6	-4.6	-2.9	-1.8	-2.1	-1.4	-1.6	-1.7	0.4	0.1
Germany	-3.0	-2.1	-1.7	-2.8	-2.5	-1.8	-1.4	-0.9	-1.3	-2.0	0.3	-0.2
Greece	-12.4	-11.9	-8.3	-8.6	-6.0	-3.2	-0.9	-0.5	-0.8	-0.3	2.0	0.2
Ireland	-2.1	-0.9	0.0	-1.3	0.5	1.0	2.3	1.6	2.8	2.0	0.7	-0.1
Italy	-10.3	-8.7	-8.2	-7.3	-6.5	-2.0	-2.0	-0.7	-0.8	-0.6	1.4	0.5
Nether-lands	-5.4	-3.5	-4.7	-4.4	-2.1	-1.6	-1.6	-0.7	0.3	0.9	0.6	0.8
Portugal	-3.7	-5.4	-5.2	-3.9	-3.6	-2.6	-2.5	-2.4	-2.3	-1.6	0.2	0.3
Spain	-4.1	-5.2	-4.5	-4.8	-2.7	-1.4	-1.5	-0.8	-0.5	0.0	0.4	0.5
Sweden	-5.2	-7.1	-7.9	-6.0	-0.9	0.6	3.4	2.1	3.9	4.4	1.4	0.3
U. K.	-4.2	-5.6	-5.6	-5.0	-3.7	-2.0	0.4	1.4	1.9	1.2	0.8	0.3
Euro area	-5.2	-4.5	-4.1	-4.2	-3.2	-1.7	-1.5	-0.9	-0.9	-0.9	0.6	0.2
European Union	-5.1	-4.9	-4.6	-4.6	-3.3	-1.7	-1.1	-0.4	-0.3	-0.5	0.7	0.2

[a]Surplus (+) or deficit(-) as percentage of potential GDP. [b]OECD estimate.

Source: OECD (2001), own calculations.

below the 3 per cent threshold in 1998, with some countries even showing a budget surplus (Table 1). Looking at the structural balances from a country by country perspective there are three countries with a structural deficit of more than 1 per cent: Portugal, France and Germany. In this context it is remarkable that Germany was the only country where the structural budget deficits have increased since the implementation of the Stability and Growth Pact, while neighbouring countries such as Austria and the Netherlands which initially showed somewhat higher structural deficits than Germany have succeeded in removing the deficit; the Netherlands even attained a structural budget surplus.

In Table 3 the actual financial balances in the period 1999-2001 are compared with the projections that have been made in the first stability and convergence programmes. As can be seen, EU-member countries show considerable differences in their budgetary ambition. One group, consisting of Denmark, Ireland, Luxembourg, Finland, Sweden and the U.K. had already reached the target in the first year (1999). The other countries projected a decline of their deficits although in general only by very moderate rates. The least ambitious five countries (Austria, Germany, France, Italy and Portugal) projected deficits of 1 per cent and more for 2001. It is worth noting that this group includes the four countries which in fact did not reach a position close to balance or in surplus in 2001. The exception is Austria which managed to reduce the deficit by much

Table 3: Projected General Government Financial Balances 1999-2001[a]

	Projected Surplus or Deficit as Percentage of GDP			Deviation of Actual from Projected Balance in 2001
	1999	2000	2001	
Austria	-2.0	-1.7	-1.5	+1.5
Belgium	-1.3	-1.0	-0.7	+0.7
Denmark	2.5	2.8	2.6	-0.6
Finland	2.4	2.2	2.1	+1.6
France	-2.3	-2.0	-1.6	+0.1
Germany	-2.0	-2.0	-1.5	-1.0
Greece	-2.1	-1.7	-0.8	+1.0
Ireland	1.7	1.4	1.6	+1.6
Italy	-2.0	-1.5	-1.0	-0.4
Luxembourg	-1.1	1.2	1.3	+4.0
Netherlands	-1.3	n.a.	n.a.	n.a.
Portugal	-2.0	-1.5	-1.2	-0.3
Spain	-1.6	-1.0	-0.4	+0.4
Sweden	0.3	1.6	2.5	+1.6
United Kingdom	-0.3	-0.3	-0.1	+1.2

[a]In the stability and convergence programmes 1998/99.

Source: Cabral (1999), OECD (2001); own calculations.

more than originally projected[3]. From Table 3 it can also be seen that for most of the EU-countries actual deficits in 2001 were lower (or surpluses larger) than originally projected. For three countries (Italy, Portugal and, in particular, Germany), actual deficits turned out to be larger than originally projected.

3 Why Have Some Countries Been Less Ambitious in Reducing Government Deficits?

While Council Regulation 1466/97 requires that countries formulate a medium-term objective for the budgetary position close to balance or in surplus, it is not precisely clear what is meant by the term "close to balance". The European Union has suggested to operationalize this term by calculating so-called "minimal benchmarks" for each country (European Commission 2001, p. 51). The benchmarks should be sufficiently low to provide a cyclical safety margin which allows the automatic fiscal stabilisers to work in recessions while keeping the actual budget deficit still below the 3 per cent reference value. The higher the sensitivity of the budget to the cycle and the higher the volatility of the economy, the higher will be the safety margin for the respective member country.

[3] In the subsequent updates of the stability programme, Austria substantially reduced its projected deficits in the course of 2000; Italy and France reduced the projection by a small amount, while Germany and Portugal adhered to their earlier projections (European Commission 2001, p. 15).

The safety margins which the European Commission has calculated and the resulting minimum benchmark deficits are shown in Table 4[4].

The minimal benchmark values are obtained as the difference between the cyclical safety margin and the reference value of 3 per cent of GDP. As can be seen, minimal benchmark values can differ among countries. For example, Finland with its strong cyclical fluctuations and above-average budgetary sensitivity needs a relatively large safety margin, which in the Commission's estimates even requires a budget surplus of 1.3 per cent or more in normal times. France, on the other hand, achieves a sufficient cyclical safety margin already when the budget deficit in normal times does not exceed 1.5 per cent.[5]

A potential reason for why some countries have reduced their deficits by less than others is that they require a smaller cyclical safety margin. Looking at Table 4, it is striking that Austria, France, Germany and Italy, which originally projected the highest deficit ratios for 2001 also exhibit the lowest safety margins. This should not be interpreted in the way that these countries are content with reducing the deficit to the — relatively high — minimal benchmark. Updated stability programmes (European Commission 2001, p. 15) show that all of

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[4] As to the method of calculation see European Commission 2001, p. 51.

[5] The Commission emphasizes that the calculated benchmarks are minimum levels. Governments may well aim at achieving lower deficits or higher surpluses than shown by the benchmark levels in Table 4, e.g. to provide an additional safety margin for unforeseen budgetary developments or to reduce the interest burden to prepare for ageing populations

Table 4: EC-Estimates of Cyclical Safety Margins and Minimal Benchmark Balances

Country	Cyclical Safety Margin (1)	Minimal Benchmark (Deficit: - Surplus: +) (2)	Projected Government Balance for 2001[a] (3)	Projected Additional Safety Margin for 2001[b] (4)
Austria	1.7	-1.3	-1.5	-0.2
Belgium	2.0	-1.0	-0.7	+0.3
Denmark	2.3	-0.7	2.6	+3.5
Finland	4.3	1.3	2.1	+0.8
France	1.5	-1.5	-1.6	-0.1
Germany	1.9	-1.1	-1.5	-0.4
Greece	1.6	-1.4	-0.8	+0.6
Ireland	2.1	-0.9	1.6	+2.5
Italy	1.8	-1.2	-1.0	+0.2
Luxembourg	3.0	0.0	1.3	+1.3
Netherlands	2.9	-0.1	n.a.	n.a.
Portugal	2.4	-0.6	-1.2	-0.6
Spain	2.6	-0.4	-0.4	0.0
Sweden	3.8	0.8	2.5	+1.7
United Kingdom	2.9	-0.1	-0.1	0.0

[a]In the stability and convergence programmes 1998/99. [b]Column (3) minus Column (2).

Source: European Commission (2001), Cabral (1999), own calculations.

(European Commission 2001, p. 53-55). Artis and Buti (2000) estimate the safety margin for unforeseen budgetary developments to be of the order of 0.5 to 1 per cent of GDP.

these countries aim at achieving a situation of budget balance or surplus by 2004. It could, however, support the view that for these countries there was relatively little pressure to proceed faster with respect to a deficit reduction because they considered the probability to exceed the threshold in case of a recession in 2001 as very low at the projected deficit ratios of 1-1 ½ per cent. However, this explanation is not fully satisfying. In Table 4 we have shown the difference between the minimal benchmarks and the originally projected budget for 2001, which can be considered as "Projected Additional Safety Margin for 2001". While most of the countries exhibit a small or even sizeable safety margin, in case of four countries (Austria, France, Germany and Portugal) the projected deficit was above the minimal benchmark, i.e. the additional safety margin was negative. While Austria and to a lesser extent, France, lowered the projected deficit for 2001 in their updated stability programmes this was not the case for Germany and Portugal. The finding that these two countries did not manage to provide an adequate overall safety margin even in the third year after the start of the Stability and Growth Pact is a point that may well be criticized and that helps to explain the particular unfavourable performance of their deficit ratio in 2001.[6]

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[6] In this respect it is worthwhile to recall the early warning of the European Central Bank: "… at the beginning of the next century a number of important countries in the EU will be brought to a position from which it will be barely possible for them to withstand normal macroeconomic fluctuations without some risk of breaching the reference value for deficits" (ECB 1999, p. 59).

A second potential reason for why some countries have been less ambitious in reducing their deficit may be seen in the different probability of sanctions in case of an excessive deficit. Looking at the group of countries with the highest projected deficits, it is striking that they comprise the largest member countries of the Euro-area (Germany, France, Italy). Thus, one might advance the hypothesis that large countries have been less eager to reduce deficits because they expect that an eventual excessive deficit procedure would be applied less stringently for large countries than for small countries. The argument behind this would be that due to the different voting shares in the ECOFIN-Council it is more difficult to find a qualified majority for sanctions against a large country than for sanctions against a small country.[7] It is, however, difficult to empirically substantiate this hypothesis. First, it does not explain the relatively low effort by Portugal, which has only 5 votes in the ECOFIN-Council. Second, one has to take into consideration that Denmark, Sweden and the U.K. which do not belong to the Euro-area and are not subject to sanctions under the Stability Pact, have nevertheless pursued a very strict fiscal policy. There are no clear signs for a close link between the probability of facing sanctions and the ambition to reduce public deficits in the EU.

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[7] Decisions have to be taken by a qualified majority which is defined as two-thirds of a total of 87 votes. Germany, France and Italy have 10 votes each, while e.g. Ireland and Finland have only 3 votes (ECB 1999).

The low ambition of some countries may also be attributed to concerns that major steps to reduce the budget deficits would have a negative effect on growth. Empirically, there is, however, little support for the hypothesis of a trade-off between deficit reduction and economic growth. Table 5 lists the EU countries by the amount of the improvement of structural balances in the period

Table 5: Structural Balances and Real Growth Rates in the EU

Country	Average Annual Reduction of Structural Budget Deficit 1992-2001[a]	Deviation of Annual GDP Growth Rate 1992-2001 from EU Average	Change in Annual GDP-Growth Rate 1992-2001 as against 1974-1991
Greece	1.3	+0.3	+0.2
Belgium	1.1	0.0	+0.1
Italy	1.1	-0.5	-1.0
Sweden	1.1	-0.1	+0.3
Netherlands	0.8	+0.7	+0.6
United Kingdom	0.6	+0.6	+0.7
Ireland	0.5	+5.6	+3.8
Spain	0.5	+0.6	+0.3
Finland	0.4	+0.8	+0.5
Austria	0.3	0.0	-0.4
France	0.3	-0.2	-0.4
Portugal	0.2	+0.5	-0.6
Denmark	0.1	+0.3	+0.4
Germany	0.1	-0.6	-1.0

[a]As percentage of potential GDP.

Source: OECD (2001), own calculations.

1992-2001. There is no indication that the growth rate of the countries which reduced budget deficits substantially (by at least 0.5 percentage points of GDP per year) generally achieved lower real growth rates than the EU average. Of the eight countries in this group, only Italy shows a real growth rate that is substantially below the EU-average. This finding is confirmed when one compares the average growth rates in the period 1992-2001 with growth rates in the preceding period 1974-1992. With the exception of Italy, all of the countries that reduced the structural deficit substantially in the period 1992-2001 achieved higher growth rates than in the period 1974-1991 during which structural deficits had been built up. A possible reason for this result is that consolidation policies have been linked to measures that had positive supply side effects, such as privatisation or cuts of subsidies and social security benefits. The role of these factors in successful stabilisations has been emphasised in particular by Alesina and Perotti (1997).

It is also worth noting that there is no indication for a trade-off between fiscal consolidation and institutional reform as presumed by Eichengreen and Wyplosz (1998). They had expressed concern that cuts of fiscal deficits as a consequence of the Stability Pact might weaken the political impetus to liberalise European labour markets. Taking the case of Germany, one finds that the relatively small consolidation effort did not go along with relatively far-reaching deregulation but rather reregulation of the labour market — (Sachverständigen-

rat 2001, p. 192-3).

4 Assessing the Stability Pact: Lessons from the First Three Years

Since deficits have so far not gone beyond the threshold of 3 per cent of GDP, there has been no occasion to observe the functioning of the excessive deficit procedure. Concerning the preventive function, however, there are several interesting insights.

First, the Stability Pact has contributed to the transparency of fiscal policies in the European Union. By providing and regularly updating stability and convergence programmes, medium-term goals and possible divergences from target paths are now much more visible to the public than before the introduction of the Pact.

Second, the member countries of the Euro-area have interpreted the term of a medium-term budget “close to balance or in surplus” in strict sense. They all project a balanced budget or a surplus for the middle of the decade. This suggests that they seek not only to provide a cyclical safety margin but also to contribute to a reduction of the interest burden.

Third, while all countries have been ambitious with respect to the medium-term budget, not all have shown the same ambition in the short run. Four countries (France, Germany, Italy and Portugal) still had sizeable deficits in the third year

of the Stability Pact — both with respect to the actual and the structural budget. The relatively low ambition of these countries can only partly be attributed to the requirement of lower cyclical safety margins or to a higher voting share in the ECOFIN-Council.

Fourth, the objection that the Stability Pact would prevent the functioning of the automatic stabilisers and result in a procylical fiscal policy has not been confirmed by recent experience. Automatic stabilisers have in fact been allowed to work, in particular in the downswing of 2001. There could, however, have been a conflict between the operation of the automatic stabilisers and the 3 per cent threshold in Germany and possibly also in Portugal if the downswing in these countries had been deeper in 2001. But this would not have been a problem of the Stability Pact as such. It rather reflects the fact that these two countries had not provided a sufficient safety margin in their budgets.

Finally, a particularly striking lesson is that there is no evidence for a trade-off between fiscal consolidation and medium-term growth. Of the eight countries which in the period 1992-2001 reduced their structural budget deficits by at least 0.5 percentage points of GDP per year, only one (Italy) showed growth rates below the EU-average. The other seven countries even managed to achieve higher growth rates than in the period 1974-91 during which structural deficits had been built up.

One conclusion that one can draw from this is that countries which have not reached a position close to balance or in surplus should be required to base their stabulity programmes on reductions of the structural deficits by at least 0.5 percentage points per year. The objection that this would be too ambitious and lead to lower medium-run growth is not supported by previous consolidation experiences in the EU.

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