FISCAL POLICY IN AN ENLARGED EU

Fabrizio Coricelli
University of Siena and CEPR

This paper analyzes the implications for acceding countries of the existing EU fiscal framework, focusing on three main issues. First, the 3% ceiling on the budget deficit does not leave sufficient room to acceding countries to run counter-cyclical policies during downturns. This is due to the much higher rate of potential output growth and volatility of rates of growth in acceding countries. Second, accession countries have much higher public investments-to-GDP ratios than current EU members. Therefore, current budgetary ceilings are much more stringent for acceding countries than for current EU members. Some form of "golden rule" seems appropriate and consistent with the main goal of convergence and cohesion among EU countries. Third, the procedures associated to the implementation of EU fiscal rules are subject to political influence. As most acceding countries are small and relatively poor countries, they risk to become members of a "second league" of the EU.

JEL classifications: E62, E63, H50, H62, P35

The procedures leading to the forthcoming accession to the EU did not involve any conditionality on macroeconomic indicators for Candidate countries (CEECs). In several (CEECs) there was a marked deterioration of the fiscal accounts during the run-up to entry in the EU. Apparently, CEECs did not perceive they would be subject to tight fiscal constraints upon entry, although the ceiling of 3% on budget deficit and the Stability and Growth Pact apply to every member of the EU.

As entry in the EU implies a complete liberalization of capital flows and the adoption of a managed exchange rate system during the transition to the Euro-zone, burgeoning budget deficits, accompanied by large current account deficits, expose CEECs to serious risks of currency and financial crises. An effective framework for fiscal policy, allowing a credible and efficient adjustment of the budget would thus be of paramount importance for ensuring that accession is accompanied by macroeconomic stability. However, the current framework for fiscal policy in the EU has several drawbacks when applied to new member states. These drawbacks reveal fundamental limits of this framework, limits that appear even more serious in an enlarged EU.

April 2004
Special issue

In this paper we analyze the implications of the existing EU fiscal framework for acceding countries, focusing on three main issues[1]. First, the 3% ceiling on the budget deficit is unlikely to leave sufficient room to CEECs to run counter-cyclical policies during downturns, as CEECs are characterized by much higher rate of potential output growth and volatility of rates of growth. Second, convergence to EU levels of income per capita requires fast growth and large investments in infrastructures, including education and R&D. Moreover, improving the environmental conditions in CEECs implies large public expenditures. CEECs will continue to be characterized in the near future by much higher public investments-to-GDP ratios than EU-15 countries. Therefore, current budgetary ceilings are much more stringent for CEECs than for current EU members. Some form of "golden rule" seems appropriate and consistent with the main goal of European Union policies that is convergence and cohesion among EU countries. Third, the procedures associated to the implementation of EU fiscal rules are subject to political influence. As most CEECs are small and poor countries, they risk to become members of a "second league" of the EU.

Interestingly, all the three points just discussed highlight fundamental issues that are of general relevance for the EU, including current member states. It is just the magnitude of the problems that appears more serious for CEECs. Thus, enlargement is an opportunity to improve upon existing EU fiscal rules.

The paper is structured as follows. In section 1 we summarize the main trends in fiscal accounts in CEECs and highlight the fundamental problem of lack of conditionality on fiscal accounts in the accession process. We argue that accession itself determined a loosening of the perceived constraints on fiscal policy. As a result, several CEECs will enter the EU with extremely large budget deficits. This raises the issue of how to reduce such deficits, both in terms of the time horizon and the measures to achieve fiscal consolidation without hampering the growth prospects for CEECs. In section 2 we discuss the implications of the 3% deficit ceiling and of the SGP for CEECs. We emphasize two main issues. First, we stress the shortcomings of the current framework when applied to countries characterized by much higher growth of potential output and higher volatility of output. The notion that the 3% ceiling represents a sufficiently large margin to absorb the cyclical effects on the budget during "normal" bad times does not seem to hold for CEECs. Thus, the risk of a pro-cyclical bias of the budget limits is very concrete for CEECs.

Second, CEECs are characterized by a ratio of public investment over GDP much higher than current EU members. The inclusion of

1. Buiter and Grafe (2003) discuss the issue and reach similar conclusions to ours, although from a different perspective, as they focus more on the long-run sustainability of public finances.

public investment in the deficit subject to the ceiling implies a significant adverse effect for CEECs. In fact, this seems to contrast with the emphasis on catching up and convergence in incomes per capita that is at the heart of EU policies. Moreover, EU structural funds are meant to be an important engine for fostering such convergence. As structural funds are directed to projects involving local co-financing, they imply on impact a negative effect on the budget and possibly difficulties to meet the budgetary ceiling. Third, we extend the discussion on the limits of the existing rules focusing on the implementation of such rules. The current crisis of the SGP is mainly connected with this issue. Enlargement is important in this respect because it makes even more urgent the establishment of an effective, transparent and fair procedure of fiscal monitoring equally applied to all countries, irrespective of their economic size. Heterogeneity of countries may be taken into account when designing fiscal rules. However, once the rules have been specified, their application has to be the same across countries. Thus, existing rules are inefficient for new members. In fact, we argue that although such inefficiencies have larger adverse effects on CEECs, they apply to all EU countries. Section 3 concludes the paper.

1. Trends in fiscal accounts in accession countries

Several candidate countries are approaching entry in the European Union with large budget deficits that have a structural nature. During the sharp economic collapse of the early 1990s, lack of access to borrowing induced a significant tightening of fiscal policy. By contrast, deficits have grown and remained high during the subsequent period of growth (Table). Budget deficits have been on average well above 3% of GDP, except for Slovenia and the Baltics. Interestingly, it appears that country size matters for fiscal policy. However, low-deficit countries, especially the Baltics, are also the countries with a currency board, or a fixed exchange rate, regime.

If compared with EU levels, debt ratios are still relatively low in CEECs. However, Hungary has a debt-to-GDP ratio rapidly approaching 60 percent, while Poland and Slovakia have debt ratios above 40 percent of GDP. It should be stressed that EU countries are not a good comparator for judging debt ratios of CEECs, that are emerging markets rather than established advanced economies. Financial sectors are still underdeveloped in CEECs and their public debts have a large component of foreign debt. If compared with Latin America, for instance, debt ratios of CEECs are of the same order of magnitude. Even after entry in the EU, as long as they remain outside the Euro-zone, CEECs debt should be considered as emerging market debt, subject to the same volatility and risks. Indeed, according to the recent EC proposal for modifying existing fiscal rules in the EU, countries with debt-to-GDP ratios below 60 percent should have more room for expansionary fiscal policy. While one could support such proposal when applied to current EU members, its rationale for new members is highly questionable.

General government net borrowing and debt in the Central European and Baltic acceding countries, 1998-2002

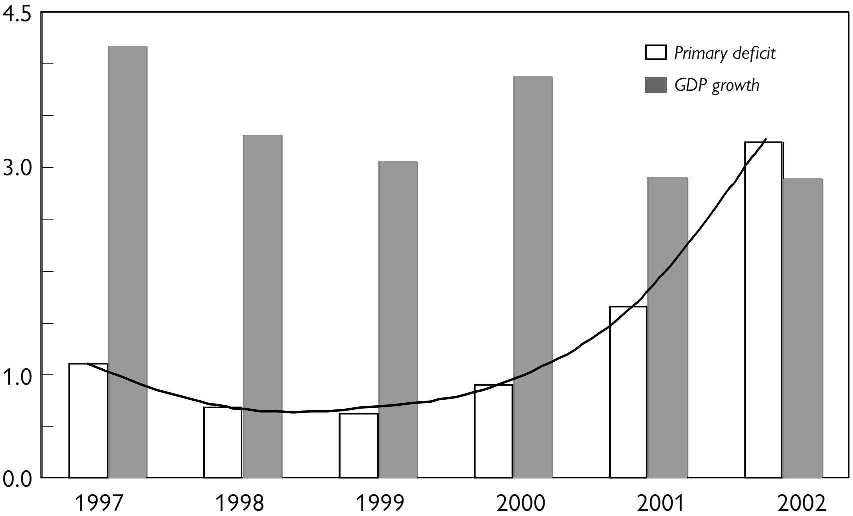
Country	1998	1999	2000	2001	2002
	Net borrowing (ESA95, in percent of GDP)				
Czech Republic	-4.5	-3.2	-3.3	-5.5	-6.7
Estonia	-0.4	-4.0	-0.4	0.2	1.3
Hungary	-8.0	-5.3	-3.0	-4.1	-9.2
Latvia	-0.7	-5.3	-2.7	-1.6	-3.0
Lithuania	-3.1	-5.6	-2.7	-1.9	-1.7
Poland	-2.3	-1.5	-1.8	-3.9	-3.8
Slovakia	-4.7	-6.4	-12.8	-5.6	-7.2
Slovenia	-2.3	-2.2	-3.2	-2.5	-2.4
Baltic countries average	1.4	-5.0	-1.9	-1.1	-1.1
Central European countries average	-4.4	-3.7	-4.8	-4.3	-5.9
	Public Debt (in percent of GDP)				
Czech Republic	13.7	14.5	17.0	23.7	26.9
Estonia	6.0	6.5	5.1	4.8	5.8
Hungary	61.9	61.0	55.4	53.1	56.3
Latvia	10.6	13.7	13.9	16.0	14.6
Lithuania	17.1	23.0	24.0	23.1	22.7
Poland	41.6	42.7	38.7	39.3	41.8
Slovakia	28.9	40.2	45.2	44.1	44.3
Slovenia	25.1	26.4	27.6	27.5	27.3
Baltic countries average	11.2	14.4	14.3	14.6	14.4
Central European countries average	34.2	37.0	36.8	37.5	39.3

Source: Kopits and Székely (2002); for 2002 figures are actual data from Pre-accession economic programs of the countries.

1.1. The nature of the fiscal deterioration in large Central and Eastern European countries

I have tried elsewhere to estimate (Coricelli and Ercolani, 2002) the structural and cyclical components of budget deficits in CEECs. Applying the EU methodology I found that budget deficits in CEECs have a structural nature, although results have to be taken with caution because the estimation of output gaps for CEECs cannot be very reliable, given that CEECs became market economies only at the beginning of the 1990s. Nevertheless, the structural nature of budget deficits can be inferred by simple inspection of the behavior of primary budget deficits and GDP growth in the last six years in Central European candidate countries (excluding the Baltic States). Indeed, Figure 1 shows that the growing primary deficits took place during a period of steady growth.

1. Deficit (in % of GDP) and growth (in %) in the Central European accession countries, 1997-2002



Source: Kopits and Székely (2002).

The high deficits of CEECs (excluding Baltic States) derived not only from declining revenue-to-GDP ratios, but, after 2000, also from increasing current expenditures. Indeed, the sharp difference in the fiscal performance of Central European Accession countries and Baltic States is due to the dynamics of expenditure, especially current expenditures. Indeed, public investments have remained rather stable as a share of GDP in all countries. In the Baltics, revenue-to-GDP ratios declined much faster than in Central European Accession countries, but such decline was more than compensated by a reduction of current expenditures. Such a process did not take place in Central European Accession countries.

Thus, except for the Baltics, CEECs are approaching entry in the EU with large structural deficits. The prospects for the post-entry period are not reassuring, as accession to the EU will probably have an adverse effect on the budget of new members. This is due mainly to the impact of co-financing of structural funds, that are going to be relatively large in CEECs.

The prospect of increasing revenue-to-GDP ratios is not very likely. Indeed, considering their level of GDP per capita, CEECs have a relatively large "size" of the government, possibly as a legacy of the socialist period (European Commission, 2003). Furthermore, CEECs attribute a key importance to attracting foreign direct investments, and thus tax competition will play an important role. As a result, revenue-to-GDP ratios are likely to continue declining.

In summary, without a change in policy, budget deficits are going to remain very high after accession. This poses the question on how new members will tackle their fiscal policy within the EU framework, that in principle applies to every EU member state and not only to members of the Euro-zone.

1.2. Institutional vacuum for acceding countries?

The lack of a clear position of the European Commission on the framework of fiscal policy that will apply to new member is hard to rationalize. This attitude seems to neglect the key institutional change brought about by the Stability and Growth Pact, that in principle has reduced the scope for flexibility in the interpretation of budgetary positions of member states and has made much more automatic the procedures to be followed for countries with excessive budget deficits.

According to the article 104 of the Maastricht Treaty "member states shall avoid excessive government deficits". In paragraph 2 the Treaty establishes the criteria to be used to evaluate compliance with the excessive deficit rule, related to reference values of 3% for the budget deficit and 60% for the debt-to-GDP ratio:

"(a) Whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:

— Either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;

— Or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.

(b) Whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace".

The Maastricht Treaty would have left ample margin of flexibility for evaluating the fiscal position of new members. The European Commission could have judged budget deficits in acceding countries as linked to exceptional circumstances and could have given time to them to adjust their budget imbalances. However, the Stability and Growth Pact has made much more precise the evaluation of fiscal positions and the procedure that the EC has to follow. As noted by a recent report by CEPR (2004), the SGP made the behavior of the EC in the excessive deficit procedure almost automatic. The only discretion is left to the ECOFIN, that has the mandate to decide whether to recommend corrective action to the country involved in the excessive deficit (ED) procedure. The SGP introduced the goal of close to balance budget in the medium term. Furthermore, EMU member states have to submit every year a stability programme, while non-EMU members a convergence programme. The EC expresses an opinion and delivers a recommendation to the ECOFIN, that in turn expresses an opinion and if needed a recommendation. For EMU members failure to follow the ECOFIN recommendations implies being declared in an excessive deficit status, that triggers imposition of fines. Non-EMU members are exempted from those fine. Nevertheless, every member state in an excessive deficit status looses access to Cohesion Funds, that for acceding countries may imply a penalty much higher than that applied to EMU members.

The resolution n. 1467/97 that introduced the SGP, specifies as well the temporary and exceptional conditions that can allow a country to pass the 3% limit on the budget. These are linked to unexpected and severe contraction in output. In the absence of these exceptional circumstances, the EC has to issue the so-called early warning, signaling that fiscal policy is not on track.

Thus, application of the rules would imply that the EC has to judge whether the fact that budget deficits in CEECs are much higher than 3 percent reflects exceptional circumstances. However, those exceptional circumstances would be totally different from those foreseen in the articles of the Treaty, as the latter refers to a particularly severe recession.

The attitude of "benign neglect" so far adopted by the EC can be criticized on two grounds. First, there is a procedural or political issue, that can be defined as "paternalistic" approach. It is obvious that the impact of budget deficits in CEECs on the performance of the EU economy is minimal or practically zero, due to the small economic size of these countries. However, the EU is based on an important principle of equality among member states. The procedure on excessive budget deficits and the Stability and Growth Pact apply to every member state, irrespective of the size of the spill-over effects associated to the fiscal policy of a specific country. The fact that fiscal rules are subject to informal decisions is worrying and it raises once more the issue of legitimacy of EU institutions, that in principle have the only mandate of ensuring application of EU rules. Although the benign neglect approach seems to favor new members, allowing them to escape harsh measures, it reveals an implicit decision of treating new members as different and part of a second league of EU countries.

The benign neglect approach can be criticized also on economic grounds. While it is true that the small size of CEECs implies that their budget deficits do not have a significant negative externality for other EU members, it is also true that the current path of fiscal policy might be highly damaging for the performance of CEECs. From the observation of recent trends in fiscal policy in CEECs, one cannot resist from stating that the attitude of EU institutions has proven a powerful weapon in the hands of national lobbies that have pushed governments in several CEECs to expand their budget deficits. A clear indication that high deficits would not be accepted within the EU fiscal framework, starting from May 2004, would have served as a strong deterrent against loose fiscal policies in CEECs. It is ironic that the paternalistic approach towards acceding countries has contributed to softening the budget constraints for national governments.

As we will argue in the next sections, a way out of this institutional vacuum is to modify existing rules in a way that they prove viable and efficient for all member states, including acceding countries. We thus turn to the discussion of the main drawbacks of existing fiscal rules in the EU, viewed from the perspective of acceding countries.

2. Shortcomings of the existing framework for new members

There are three main areas that make the current EU fiscal rules not appropriate for new acceding countries. The first relates to the 3% budget deficit limit; the second to the absence of a "golden rule" and the third relates to the procedures for assessing fiscal stance and the behavior of national governments.

2.1. The 3% deficit limit

Incomes per capita in acceding countries are on average 40 percent of those of the average EU country. Convergence to EU levels of GDP per capita is going to be a long term phenomenon. Thus, for a few decades CEECs should display higher rates of growth than those of EU countries. Assuming the Barro well-known rule of thumb on convergence, CEECs should grow at a rate that is 2 percent higher than the average EU. As the average rate of growth of potential output is around 2 percent in the EU, potential output in acceding countries can be expected to grow between 4 and 5 percent per annum. The volatility of GDP growth is also likely to be much higher than that of EU countries. This implies that with neutral fiscal policy stance, fluctuations in cyclical budget balances should display a much larger amplitude, following the higher amplitude of fluctuations in output, if the output elasticity of both revenues and expenditures are similar to those in the EU countries. In Coricelli and Ercolani (2002) it is estimated that the output elasticity of total revenues is around one for most CEECs, while the expenditure elasticity with respect to the output gap is smaller than that found for EU countries. Overall, the elasticity of the budget balance to the output gap is about 0.4 for CEECs, not far from the 0.5 for the average of EU countries. Therefore, higher output volatility is going to be translated in higher budget volatility. Looking at the period 1996-mid 2002, a recent paper by the ECB finds that CEECs posted an average rate of growth of GDP of about 4% against a 2.2% of Euro area countries. Volatility was much higher in CEECs, with a standard deviation of output growth almost three times higher than that of the Euro area (Süppel, 2003). The study concludes that since higher growth and higher volatility of growth reflect a catching up process, they are going to persist in the medium run. Given these structural features, the 3% ceiling on the budget deficit does not represent a sufficient margin to absorb cyclical swings in budget deficits. For current EU members, with an estimated elasticity of the budget to the output gap of around 0.5, the 3% budget deficit limit represents a wide enough margin to absorb regular cyclical fluctuations in the budget. While this is disputable even for current EU members, it is hardly applicable to acceding countries.

A second possible drawback of existing rules is the pro-cyclical bias, associated to the fact that the budget deficit deteriorates during recessions and if it approaches the 3% ceiling, governments have to undertake adjustments during "bad times". According to Gali and Perotti (2003), the Maastricht criterion on the budget deficit has not been a constraint on counter-cyclical policies by countries in EMU. This effect is derived through an estimate of the impact of the output gap on the behavior of the cyclically adjusted deficit, contrasting the pre with post-Maastricht phase. They find no effect of a pro-cyclical bias after the introduction of fiscal constraints. A recent report by CEPR (2004) broadly confirms this result. It finds that only in the case of Portugal and Italy there has been a tightening of fiscal policy during a downturn. However, it could be argued that a similar effect would have been detected for Germany and France, had the excessive deficit procedure been approved by the ECOFIN. This would have implied a pro-cyclical stance in 4 members of the EMU during the most important episode of downturn of the post-Maastricht period. Thus, although there is no strong evidence of pro-cyclical bias in the existing fiscal rules, it clearly emerges that sizable slowdown in the rate of growth of output sharply increases the probability of hitting the 3% ceiling, a problem that is bound to be much more serious for acceding countries, as the magnitude of the changes in growth rates is likely to be much higher than that of current EU members.

The approach followed by Gali and Perotti, however may not be a relevant test of pro-cyclical fiscal policy, as the cyclically adjusted budget does not necessarily reflect discretionary fiscal policy. With few exceptions, discretionary policy in response to changes in economic activity relates to expenditure. Expenditure plans are generally linked to expected GDP growth. Therefore, both GDP and expenditure tend to have a trend component. The pro or counter-cyclical stance of fiscal policy can thus be detected by looking at the correlation between the cyclical fluctuations of expenditure and of GDP (see Talvi and Vegh, 2000). Applying this methodology, we found that CEECs, as other emerging markets display a pro-cyclical fiscal policy. As government consumption does not vary automatically with the cycle, it can be used as a proxy for the discretionary component of fiscal policy. A positive correlation between the cyclical components of government consumption and of GDP is a measure of the pro-cyclicality of fiscal policy. Indeed, for several CEECs such correlation was positive or close to zero during the period 1995-2003 (Coricelli and Eianchovina, 2004). This indicates that so far there has been little counter-cyclical role for fiscal policy in CEECs. The fact that EU fiscal rules do not provide effective disincentives for pro-cyclical policies, either during good or bad times, might be a serious drawback for CEECs that tend to have pro-cyclical fiscal policies.

The second area in which existing EU fiscal rules are inadequate for acceding countries is the one related to the treatment of public investments as any other expenditure in the definition of the budgetary targets.

2.2. Public investment and the golden rule

Abstracting from the general relevance of the golden rule, we simply discuss its implications for acceding countries. The ratio of public investment to GDP in acceding countries is on average around 4%, as opposed to about 1% in EU countries. Thus, the adoption of some form of golden rule would make a large difference for acceding countries. Empirical evidence on the relationship between public expenditure and growth indicates that public investments tend to increase the rate of growth, raising potential output of the economy. In a EU characterized by disappointing figures on growth and very low estimated growth of potential output, the issue of public investment cannot be underestimated, especially for acceding countries[2].

It is worth stressing that one of the main justifications for the 3% limit on the budget deficit was probably chosen in order to allow

2. Creel (2003) argued that a golden rule would dominate the current EU fiscal rules on the basis of the criteria for optimal fiscal rules suggested by Kopits and Symansky (1998).

achievement of a balanced budget without curtailing public investments. Indeed, it was observed that the ratio of public investment to GDP in Germany, where the "golden rule" is foreseen in the Constitution, was slightly 2.3% on average during the period 1970-1990 (see Buiter and Grafe, 2003). If one were to use the same logic for CEECs, a limit of about 4% of GDP on the deficit would be desirable. Furthermore, there is a strong pressure for increasing public investment in acceding countries. This is due to the need of investments in infrastructure to sustain the process of catching-up with EU countries. EU structural funds will partially finance such investments, but there is a component of local co-financing that will increase budget deficits in CEECs. Adoption of the golden rule would permit to take into account such large differences among countries and at the same time avoid establishing different deficit limits for different countries. Of course, the golden rule could be implemented in a framework of expenditure targets, without deficit targets, as discussed below.

The third area of possible shortcomings of EU fiscal rules in an enlarged EU relates to the implementation of the rules and the whole process of evaluation of fiscal policies.

2.3. Credibility of rules and credibility of policy-makers

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

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

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

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

Summing up, a virtuous country should have counter-cyclical deficits due to the functioning of automatic stabilizers. This functioning of automatic stabilizers is fully consistent with the 3 percent limit for well-behaved countries.

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

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

If governments were welfare maximizers, they would generally follow a fiscal rule consistent with tax smoothing. This amounts to set expenditure accordingly to the expected growth of potential output[3]. Abstracting from measurement errors of potential output, this rule would imply a structural balanced budget and cyclical budget balances proportional to the deviation of the rate of growth from potential growth. Actual developments of GDP, and not the level of the output gap, will determine the movements in the budget balance. Expenditure will be by construction counter-cyclical, with a unitary elasticity of expenditure-to-GDP ratio with respect to the deviation of growth from potential. Although this cyclical movements of expenditure is different from what are commonly defined as automatic stabilizers, in fact they work in a similar fashion as potentially stabilizing forces.

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

Figure 2 plots this measure of discretionary policy (DP) for the period 1999-2002 in EMU countries and links it to the change in the cyclically adjusted balance.

It is remarkable that the two measures give a radically different picture. Indeed, they are negatively related, although such a relationship may not be statistically significant. If a change in the cyclically adjusted balance reflected a true change in discretionary policy, the two variables

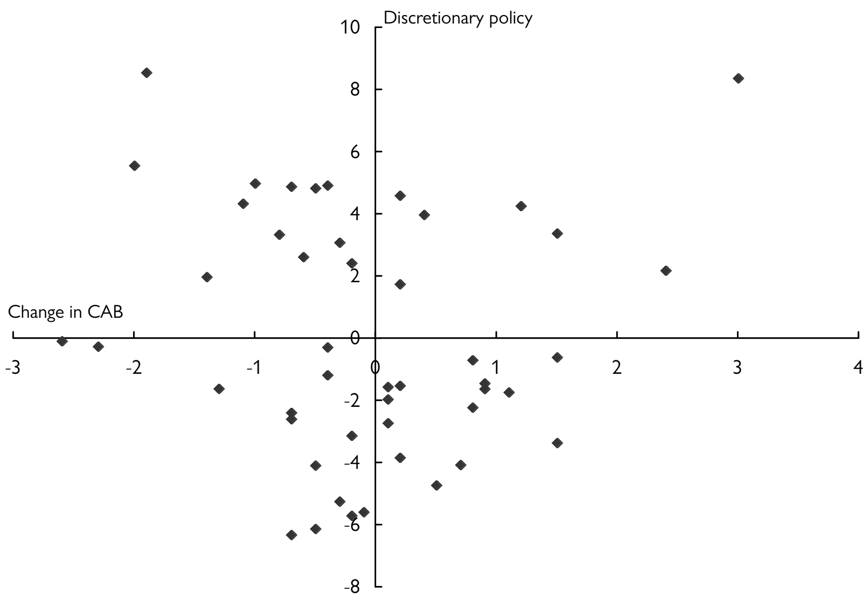
3. See Coricelli and Ercolani (2002) on this type of rule.

should be positively related, with most of the observation in the North-East and South-West quadrants. In fact, the larger number of the observations are in the other two quadrants.

Thus, even with the amendments proposed by the EC, the current framework is affected by ambiguity of interpretation of fiscal stance, leaving room to political influence on such interpretations. The Stability and Growth Pact and the numerical limit of 3% on the deficit are an example of how rules can be simple but at the same time highly ambiguous, especially if the changes proposed by the EC will be adopted. The 3% limit is very simple and within the SGP the procedures that the EC has to follow are roughly automatic. However, the fact that ECOFIN has the final word on whether the ED (Excessive Deficit) procedure should be adopted, combined with controversial measures, such as the cyclically adjusted balance, used to evaluate fiscal stance, reduce the credibility of EU fiscal rules and make its implementation subject to decisive political interference.

We next analyze the ambiguity of existing rules and the implications for acceding countries.

2. Discretionary policy and changes in the cyclically adjusted balance, 1999-2002



Sources: European Commission (AMECO database) for the cyclically-adjusted budget, and Buti and van den Noord (2003) for the discretionary policy indicator.

2.4. Lessons from the German case in the period 2001-2003

According to the defenders of the SGP, the breach of the 3% ceiling should occur only in exceptional circumstances, in particular during a deep recession. The notion of safety margin is based precisely on the idea that if a country keeps its budget deficit not too far from zero, the 3% limit would be hit when the output gap is around -6%. In the case of Germany, however, during 2001-2002, the period in which fiscal accounts displayed a sharp deterioration, the output gap was positive in 2001 (actual output was above its trend) and only marginally negative (-0.3) in 2002[4]. In 2003, the worst year for the German budget deficit, the output gap was only -1.6 percent. Similarly, in France in 2002 there was a sharp deterioration of fiscal accounts while the output gap was still positive. Of course, it is well known that there are serious difficulties in measuring output gaps and cyclically adjusted deficits. Nevertheless, these concepts are at the heart of the EC methodology. According to this methodology, the German budget deficit for the period 2001-2003 is defined as almost entirely "structural".

Literally speaking, this means that the cyclical position had nothing to do with the observed deficit. If one abandons the EC-framework and simply looks at the rate of growth of output, one would note the sharp slowdown of the economy during the period 2001-2003, with a shift from an average rate of growth of more than 2% in the period 1997-2000, to practically a stagnating economy in the period 2001-2003. Taking into account the cyclical position, EC calculations indicate that during 2002-2003 there was no significant deterioration of the CAB. Therefore, the reason of the fiscal problems has to be found in the year 2001, when the structural deficit jumped from 1.9 to 3.3% of GDP. Can one conclude that fiscal policy in Germany became loose during the period 2001-2003 as a result of discretionary measures of the German government? The EC approach would leave no doubt on the positive answer.

A more accurate analysis, however, leads to a very different picture. First, let us point to the indisputable fact that revenue to GDP ratio fell significantly in 2001 and this contributed to 1.6 percent of GDP deterioration of the budget. This fall was likely underestimated by the German authorities. It is true as well that also the EC did not foresee such a large decline in revenues. One can thus talk of a genuine unexpected decline in revenues. We would like to draw the attention to the deterioration that is not related to the revenue side, but to expenditure. Indeed, it is on the expenditure side that the limits of existing fiscal rules are more apparent. In the budgetary process, expenditure plans are built on projected output. What happened in the period 2001-2003 is that there was a very large forecast error on GDP

4. Data from AMECO Database, European Commission.

growth. Taking the forecast by the EC such error was equal to 4.2 percentage points during the three year, with the largest error in 2001. Such forecast error, therefore, accounted for a cumulative deterioration of about 2 percentage points of GDP in the budget deficit. What can we conclude from this tedious reconstruction of effects? The first conclusion is that the existing indicators used by the EC to evaluate the fiscal policy of EU governments are misleading, and this is recognized in the two papers by economists at the EC indicated above (Buti and Van den Noord, 003; Larch and Salto, 2003). What is surprising is that these papers do not draw any conclusions on the need to modify the framework for assessing fiscal policy in the EU. For instance, Larch and Salto (2003) conclude that there is an opportunistic behavior by governments, that for political reasons tend to overestimate growth.

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

All these issues will become more relevant in an enlarged EU as forecast errors for acceding countries are bound to be larger given the higher standard deviation of GDP growth in the new member countries.

It is unclear whether from the current crisis of the SGP it will emerge a fundamental reform of EU fiscal rules. In the summer of 2003 the EC has put forward a proposal for some modifications of the SGP. Such modifications, however, do not tackle the three problems we discussed above.

In Coricelli and Ercolani (2002) we argued that a more suitable rule for an enlarged and more heterogeneous EU would be a simple expenditure rule, according to which expenditures would grow at the same rate as that of potential output. Here we wanted to stress the need for fundamental changes to the EU fiscal framework in an enlarged EU. Therefore, we give a sketch of the proposed rule. We believe it could serve as the framework for evaluating fiscal stance in the enlarged EU. It makes redundant the 3% ceiling, but it is compatible with a target of stable debt-to-GDP ratio over the medium run.

3. Conclusion

In this paper we wanted to add the dimension of the enlargement to the already heated debate on EU fiscal rules. From the analysis it emerged that the main drawbacks of current rules from the perspective of acceding countries reveal fundamental shortcomings of the fiscal framework of the EU. Enlargement makes even more visible these shortcomings.

References

Buiter, W. H. and Grafe, C. (2003). 'Patching the Pact: Some Suggestions for Enhancing Fiscal Sustainability and Macroeconomic Stability in an Enlarged European Union', forthcoming in *The Economics of Transition*.

Buti, M. and Van den Noord, P. (2003). 'Discretionary fiscal policy and elections: The experience of the early years of EMU', OECD, Working Paper, No. 351.

Centre for Economic Policy Research (CEPR) (2003). *Monitoring European Integration*, No 13, London.

Coricelli, F. and Eianchovina, E. (2004). 'Shocks and volatility in Accession countries of Central-Eastern Europe', The World Bank, mimeo.

Coricelli, F. and Ercolani, V. (2002). 'Cyclical and Structural Deficits on the Road to Accession: Fiscal Rules for an Enlarged European Union', *CEPR Discussion Paper*, No. 3672.

Creel, J. (2003). 'Ranking Fiscal Policy Rules: the Golden Rule of Public Finance vs. the Stability and Growth Pact', OFCE, Working Paper, No. 2003/4.

Gali, J. and Perotti, R. (2003). 'Fiscal Policy', *Economic Policy,* CEPR, October.

Kopits, G. and Symansky, S. (1998). 'Fiscal Policy Rules', *IMF Occasional Paper*, No. 162

Kopits, G. and Székely, I. P. (2002). 'Fiscal Policy Challenges of EU Accession fro Central European Economies', International Monetary Fund, mimeo.

Larch, M. and Salto, M. (2003). 'Fiscal rules, inertia and discretionary fiscal policy', *European Economy Economic Papers*, No. 194, European Commission, October.

Süppel, R. (2003). 'Comparing Economic Dynamics in the EU and CEE Accession Countries', European Central Bank, Working Paper Series, No. 267.

Talvi, E. and Vegh, C., (2000). 'Tax Base Variability and Procyclical Fiscal Policy", NBER, Working Paper, 7499.