
*Fiscal Policy in Economic and Monetary Union* by Marco Buti and Daniele Franco consists of twelve chapters reproducing materials published in field journals between 1998 and 2003 and a postscript. On the face of it, one may be tempted to conclude that this is a book *in memoriam* of an old friend, the Stability and Growth Pact. It is not the case. Chapter by chapter, a consistent argument is made in favour of the peculiar fiscal rules endorsed by the EU through the adoption of the SGP; in the postscript the most recent reform of the Pact, triggered in March 2005 by the repeated failures of a number of countries to respect the 3% ceiling on deficit, is evaluated against the normative prescriptions at the origin of the Pact itself as well as the constraints imposed by the political economy of the Union and found – albeit partially – satisfactory.

The defence of the SGP offered by Buti and Franco rests on two pillars: (i) fiscal discipline is a pre-condition for fiscal flexibility; (ii) the very nature of the Union calls for the adoption of fiscal rules and at the same time severely limits the set of enforceable ones.

The book opens with a bird’s eye view of the theories of fiscal rules across time to focus on EU ones (chaps. 1 and 2). Their novelty stems from the fact that they apply to fiscally sovereign countries, a large subset of which share monetary policy. Thus, EU fiscal rules find their normative underpinning in the externalities fiscal indiscipline, whose adverse effects on individual countries are weakened once in the monetary union, imposes on the members of union itself. If the benefits from fiscal discipline are clear enough, less so are the costs. According to Buti and Franco, the view that fiscal discipline can only be obtained by “trading in” fiscal flexibility is unwarranted. Recent developments in the economic literature show that fiscal expansions in periods of fiscal stress can adversely affect investment decisions – through high interest rates due to an increased default risk – as well as consumption – through the anticipation of unavoidable and not too far off in
time new debt stabilisation programmes. Empirical evidence in favor of non–Keynesian effects in times of fiscal stress is mixed, but governments’ responses to severe recessions via fiscal policy vary with the debt level a country is burdened with. In particular, over the period 1960–1997 governments in low debt and deficit countries have made much more use of fiscal policy in the face of severe recessions than their colleagues in high debt and deficit ones (chap. 3). Established that fiscal discipline is conducive to fiscal flexibility, the next step is to ascertain whether the provisions of the SGP are conducive to – or compatible with – fiscal flexibility. By requiring countries to aim at medium-term objectives of budgetary positions close to balance or in surplus, in the words of Artis and Buti, “…the Stability and Growth Pact can be interpreted as a commitment device to recover room for manoeuvre for fiscal policy to sustain the cycle.” (p. 38). Key to achieve the goal of fiscal flexibility through the SGP are an appropriate choice of medium-term fiscal targets (chap. 3); a proper design of automatic stabilizers (chap. 4); “soft coordination” between monetary and fiscal authorities (chap. 5).

Alongside raising concerns over insufficient stabilization, the SGP has been under attack also for being “myopic”. The 3% ceiling on deficit would have negative effects on public investments and, through this channel, on growth. Still, the adoption of a golden rule would not be appropriate for EMU countries (chap. 6). Under the latter, opportunistic behaviour – favoured by the difficulties of multilateral surveillance – may arise which will postpone (possibly indefinitely) the reduction of deficit and debt required to shield EMU countries from reciprocal externalities and to recover fiscal flexibility in the medium term. In the same line of reasoning, it has been argued that the SGP pay scarce attention to the issue of long-term fiscal sustainability, especially in the light of European demographic developments. The very first defence of SGP on this issue (attempted in chap. 7) is that “sustainability is a central tenet of the Maastricht Treaty.” (p. 121) and the EU approach to the problem through the 3% deficit ceiling and the 60% debt to GDP ratio is a pragmatic one given “the difficulty to firmly base on theoretical grounds any benchmark against which to assess sustainability.” (p. 121). Nevertheless, the SGP could accommodate more consideration for sustainability. In fact, “The articulation of the medium-term budgetary targets could be extended to (a) the financial fragility of the country embodied in stock of public debt and (b) the threat to long-term sustainability given by the implicit liabilities of pension systems.” (p. 206, chap. 11). The design of the SGP overlooks also a crucial development in many countries’ public finances, possibly set in motion by the deepening of the Union itself: