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Damir Šehović *

* *Faculty of Economics Podgorica*

E-mail:
damirsehovic@yahoo.com

Analysis of Fiscal Rules in the European Monetary Union

Abstract: The EMU fiscal system is specific in many areas compared to other classic fiscal systems of national states. Specific features mainly reflect in the implementation of economic policy within the EMU which is carried out by combining a common centralized monetary policy under the ECB jurisdiction and decentralized fiscal policies under the jurisdiction of the member states. The member states` sovereignty in governing their fiscal policies is one of the key causes of the EU fiscal system underdevelopment, i.e. its indigent structure in relation to "standard fiscal systems".

More indigent structure of the EU fiscal system is reflected in the fact that it consists of only three segments. The first one refers to the EU budget which is also the only instrument for implementing fiscal policy at the supranational level. The second one refers to the harmonization of taxation systems in accordance with inputs and other legislation adopted at the EU level with the aim of fostering the single internal market. Finally, the third segment refers to the fiscal policy coordination of the EMU member states related to appropriate fiscal rules, which mainly stem from the Maastricht convergence criteria and the Stability and Growth Pact.

Key words: fiscal policy, EMU, fiscal rules, Stability and Growth Pact, reform.

JEL classification: E52, E61 and E62

1. Fiscal rules as the factor of maintaining economic credibility

In the most rigid sense, fiscal rules are defined as legislative or constitutional limitations of the fiscal policy through numerical rules which regulate specific

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restrictions of fiscal indicators such as budget balance, public debt, public expenditure, and taxation. The rules are introduced due to the concern that, for various reasons, holders of fiscal policy will not be able or willing to optimally pursue fiscal policy without external pressure conducted through fiscal rules.

Their goal is to reduce motivation of the fiscal policy makers for excessively expansionary fiscal policy in general, especially in the period of economic prosperity. Moreover, they are the tools for eliminating or, at worst, diminishing the possibility of giving priority to short-term over long-term economic policy goals, favouring certain interest groups on various grounds by the holders of economic policy, taking into account political but not economic cycles and so on.

In practice, there have been different reasons for implementing the fiscal policy such as:

- Guaranteeing macroeconomic stability (in post-war Japan);
- Increasing fiscal policy credibility and support in eliminating deficit (in several Canadian provinces);
- Ensuring long-term fiscal policy sustainability, especially in the contest of population aging (New Zeeland);
- Minimizing the overflow of the negative externalities between EMU states (Kennedy, Robbins and Delorme, 2001, page 239).

So, the fiscal rules in some way fetter discretion of the economic policy subjects which will lead to different fiscal disorders because of its too expansive character. Many factors are quoted in literature as the causers of violating fiscal discipline. It seems that the key intention for shifting the interagency debt is to transfer renunciation caused by a decrease of consumption and fiscal consolidation to some future governments or generations, as well as the abuse of fiscal policy for political purposes, more precisely its apprehension as the tool for winning the elections.[1]

Mentioned above are the arguments not only in favour of the need to implement the rules, but in favour of adequate formulation. In that regard, it is necessary to emphasize the consideration of fulfilment of some characteristics during the selection of fiscal rules. It should be considered that fiscal rules have to be (Kopit and Symansky, 1998):

- Properly defined;
- Transparent;

[1] For the causers of fiscal discipline violation in the situation of the absence of fiscal rules, see: Wren-Lewis, 2011; Wyplosz, 2012.

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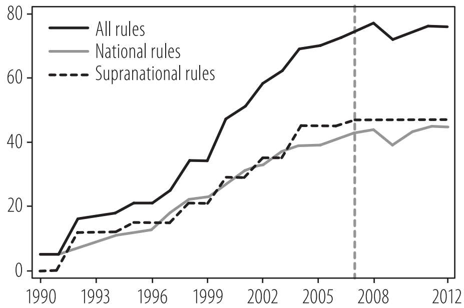
- Adequate;
- Simple;
- Flexible;
- Consistent;
- Applicable;
- Efficient.

Despite the fact that some authors oppose the implementation of fiscal rules, the prevailing opinion in theoretical researches lists more positive than negative aspects. The key reason for significant increase of the number of states which have implemented fiscal rules over the past decades that has risen from 5 in 1990 up to 76 in March 2012 is shown in Figure 1.

Figure 1: Number of states which implement fiscal rules



Source: Schaechter, Kinda, Budina and Weber, 2012; page. 11.

The reasons for increased implementation of fiscal rules over the past three decades are different, starting with those which resulted from banking and financial crisis in 1990s, the debt crisis in Latin America, efforts to reduce negative trends of deficit and debt growth, and the need to improve financial position in order to ensure fiscal discipline after the crisis.

With the aim of limiting the member states to pursue fiscal policy which is not harmonized with the needs set up by the monetary union, supranational fiscal rules were introduced in 47 EU member states and other currency unions. As national fiscal policies remained within the authority of the EU Member States and taking into account that the achievement of price stability is the common key objective of EMU monetary policy- which is practically impossible to achieve without coordination with other economic policy instruments, especially fiscal policy; there is a further need for disciplining national fiscal policies.

The aforementioned disciplining is conducted by appropriate restrictions and rules (supranational) to which fiscal policy holders must adhere in order to avoid inflation and monetization of fiscal deficits arising from improper and careless governing of fiscal policy. Providing price stability and avoiding inflationary tendencies is usual theoretical explanation for the necessity of implementation of EMU fiscal rules (European Commission, 2004).

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So, the main goal of supranational fiscal rules is the confining of national fiscal policies within the EMU, which is specified in the Maastricht Treaty and the Stability and Growth Pact.

The Maastricht Treaty (the Treaty) represents a document that defines not only the pillars of the monetary union but also the convergence criteria which countries have to meet in order to become an EMU member. It was created as a result of the intention to prevent fiscal crises that would have a negative impact on the member states, and also the efforts to achieve the primary goal set by the ECB - price stability.

The Treaty considers fiscal discipline in two ways. The first one is related to the contractual obligation which prohibits taking over debts from the member states and the Union, which represents a step towards eliminating moral hazard problems caused by the member states` expectation that someone else will cover their debt. The second way to increase chances for a sustainable fiscal policy pursued by the member states is via the convergence criteria which prevent the occurrence of excessive deficits. Two criteria connected to fiscal policy are envisaged, whereby the first one refers to the fiscal deficit limitation to 3% of GDP, and the second one refers to limiting the public debt to 60% of GDP.[2]

The logic behind formulating the abovementioned limitations is that, on one hand, this aims to eliminate the possibility of causing interest rate growth within the EMU members, by excessive growth of the budget deficit and public growth. On the other hand, excessive deficits could negatively reflect on the monetary policy credibility of and jeopardize the primary objective of price stability.

Therefore, based on the content of the Maastricht criteria, it can be concluded that fiscal sustainability is the key requirement in the fiscal policy framework to be achieved within the monetary union. The reason for this is the fact that an unsustainable fiscal policy could generate excessive macroeconomic instability and significantly hamper the key objective towards the ECB strives.

As Fatas and Mihov (2010) notice, potential tension between fiscal and monetary authorities is present in every economy, whereby abovementioned tensions could

[2] Limitations regarding budget deficit of 3% and public debt of 60% of GDP is connected in the way that under the assumption of a nominal growth rate of 5% (3% real growth and 2% inflation) the connection between 3% and 60% becomes visible in mathematical sense as 3% is actually 5% from 60%, while the connection in economic sense is reflected through the fact that public debt will stabilize at 60% of GDP in case of budget deficit from 3% and 5% of nominal growth.

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be more expressed within monetary union due to the fact that fiscal policy is decentralized and monetary policy is centralized, why coordination is more difficult to establish or it is in partial interest of some national economies. All listed make the need for the convergence criteria more obvious since it is apparent that health and sustainable fiscal and monetary policies are of fundamental importance for the monetary union success. The opposite would harm the policy credibility and, in the context of the monetary union, could impact the creation and overflow of negative externalities among the member states through interest rate channels.

The convergence criteria stipulated in the Maastricht Treaty are additionally strengthened by adopting the Stability and Growth Pact, all with the aim of ensuring that the member states remain committed to fiscal prudence after becoming the EMU members.

It is necessary to emphasize that many authors criticize the convergence criteria relating to fiscal policy, i.e. the content of mentioned fiscal rules. The first criticism argues that in this way member states are disabled to respond properly to a crisis and its negative implications, which can generate complex economic and political consequences. The argument is reasoned by the fact that any deeper recession in several countries could induce political reaction against the EMU due to the rigid rules which prevent fiscal policy holders to manage adequately demand pressures caused by the crisis. Another criticism is related to the fact that the mentioned fiscal limitations apply to all countries equally, regardless of the number of macroeconomic differences among them. Further, there are some criticisms connected with the insufficiently explained methodology which lead to limitations of budget deficit to 3% and public debt to 60%, and so on (Eijffinger and De Haan, 2008, pages 85-86).

2. Efficiency and effectiveness of the Stability and Growth Pact

In order to avoid excessive deficit, and in function of ensuring fiscal discipline which is essential for achieving macroeconomic stability within the EMU, the Stability and Growth Pact (the Pact) was founded in 1997. The Pact recognizes the establishment of budget balance as the midterm fiscal policy objective (three years). Therefore, the purpose of the Pact consists of providing additional explanation of the procedures in case of excessive deficit, and specifying the manner of reporting and procedures to sanction non-compliance with the rules set. In fact, the Pact consists of three elements: defining “excessive deficit”, determining preventive measures in order to avoid excessive deficit, recognizing corrective measures, including the sanctions.

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Regarding the first element, excessive deficit is defined as the deficit above 3% of GDP, while the obligation of drafting midterm budget is envisaged, which must be close to the balance or in surplus, so the space for automatic stabilizers` operation could be given. In the function of achieving necessary flexibility, the provisions of the Pact related to the level of permitted deficit are not applicable if GDP decline is more than 2%, while in case of GDP falling between 0,75% and 2%, a deficit higher than excessive is possible, but with the consent of the EU Council of Ministers.

The second element of the Pact refers to preventive measures, namely for the supervision of budget position via the Early Warning System and short-term surveillance. The Early Warning System is based on a medium-term projection of budgetary positions so it could recognize any potential obstacles regarding the observance of fiscal rules set by the Pact in an early phase. Namely, stabilization program, which the member states have to present, represents a document about midterm budgetary positions and plans, aimed at achieving budgetary balance or surplus. The assessment of compliance between the program and guidelines of the economic policy which are determined at the supranational level, are conducted by the Council, which decides about the countries` ability to maintain deficit at 3% of GDP. In contrary, the Council submits recommendations for amending the program to respective state. In contrast to the early warning system, the short-term surveillance encompasses semi-annual reports which are the base for making conclusions about current budgetary positions that are used for deciding about the existence of excessive budget deficit.

Corrective measures, respectively excessive deficit procedures apply in cases of the existence of the deficit, and encompass:

1. Council's recommendations given to member state in order to eliminate imbalance in the period of four months;
2. Publication of the Council's recommendations if the specific activities are not undertaken by the required deadline;
3. Imposition of detailed measures to reduce the deficit, if a member state fails to comply with recommendations;
4. Introduction of appropriate sanctions, of which the most important one is pledging an interest free deposit depending on the level of deficit in the fixed amount of 0.2% of GDP and the variable amount of 0.1% of GDP for each percent of deficit above the reference value of 3%, for the cases when a member state continues failing to follow recommendations adequately.

Time frame of the procedure in case of excessive deposit is shown in Table 1:

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Table 1: Time scale for the implementation of the procedure in case of excessive deficit

Time	Measures
1 March (year t) or 1 September (year t)	Member state submit date on their public finances to the Commission
1 June (year t) or 1 December (year t)	The Council decides on the existence of excessive deficit based on Commission report, and issues recommendations to the member states concerned
1 October (year t) or 1 April (year t+1)	The Council considers whether the undertaken actions are been taken and whether recommendations should be made public
1 November (year t) or 1 May (year t +1)	The Council decides on measures to be taken by the member states concerned to correct the excessive deficit
1 January (year t+1) or 1 July (year t+1)	The Council imposes sanctions on the member states concerned
1 May (year t+1) or 1 November (year t+1)	The Council decides on an intensification of the sanctions or abrogation of the excessive deficit

Source: Eijffinger and De Haan, 2008; page 89

Implementation of the Pact, particularly in the first few years, gave satisfactory results, since improvement of the fiscal parameters occurred in that period, namely, a decrease of the participation of public debt in GDP and maintaining macroeconomic stability. The credibility of holders of economic policy within the EMU has been enhanced, and the ECB's position has been significantly strengthened due to the compliance with the implementation of fiscal policy in the first years. The Pact played an important role in fiscal policy coordination. However, difficulties in the implementation especially escalated during 2003 and 2004 when countries such as Germany and France faced with disrupted fiscal balance, which negatively reflected on fiscal indicators, and that is why serious considerations to reform the Pact have been taken into account.

Deterioration of fiscal indicators which has intensified since 2003 (as shown in Table 2), permanent criticism of "rigidness" and lack of flexibility, equability and insufficient attention given to the specific economic circumstances of the individual member states, are dominant reasons to start the reform process of the Pact. Professional literature lists proposals for the reform focuses. In a variety of proposals, the most relevant that could be singled out indicate doing the following:

- Emphasize the need of putting the accent on the quality of public finances - Blanchard and Giavazzi (2004), Fitoussi and Creel (2002);
- Emphasize the importance of shifting the focus of the Pact from deficit to public debt and maintenance - Buiter and Grafe (2002) and Pisani–Ferry (2002);

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- Emphasize the importance of replacing numerical rules with fiscal institutions and market discipline-Wyplosz (2005);
- Reject the need to significantly reform the rules, advocate the status quo or demand finer adjustment of the existing rules-Buti, Eijffinger and Franco (2003) and Smaghi (2004);
- Emphasize the importance of implementation and not changing the existing rules-Gros, Mayer and Ubide (2004).

Table 2: The development of fiscal indicators after the implementation of "original" Pact (% GDP)

	1998	1999	2000	2001	2002	2003	2004
General Government budget balance							
Belgium	-0.8	-0.5	0.1	0.4	0.0	0.1	0.0
Germany	-2.2	-1.5	-1.1	-2.8	-3.7	-4.0	-3.7
Greece	-4.3	-3.4	-4.0	-5.4	-4.9	-5.8	-6.9
Spain	-3.0	-1.1	-0.9	-0.5	-0.3	0.0	-0.1
France	-2.6	-1.7	-1.5	-1.6	-3.2	-4.2	-3.7
Ireland	2.4	2.5	4.4	0.8	-0.6	0.2	1.5
Italy	-2.8	-1.7	-1.9	-3.1	-2.9	-3.4	-3.4
Luxemburg	3.2	3.3	5.9	5.9	2.0	0.2	-1.1
Netherlands	-0.7	0.6	1.5	-0.2	-2.0	-3.1	-1.9
Austria	-2.3	-2.2	-1.8	0.0	-0.5	-1.5	-1.1
Portugal	-3.0	-2.7	-3.2	-4.3	-2.9	-2.9	-3.2
Finland	1.7	1.7	7.0	5.1	4.1	2.5	2.3
Euro area	**-2.2**	**-1.3**	**-1.0**	**-1.8**	**-2.5**	**-3.0**	**-2.8**
Cyclically adjusted budget balance							
Belgium	-0.4	-0.6	-0.9	0.0	-0.2	0.4	0.0
Germany	-1.7	-1.1	-1.7	-3.3	-3.7	-3.4	-3.4
Greece	-3.4	-2.6	-3.5	-5.4	-5.0	-6.2	-7.7
Spain	-2.6	-1.4	-1.9	-1.4	-0.8	-0.2	0.0
France	-2.5	-2.1	-2.6	-2.6	-3.8	-4.1	-3.6
Ireland	1.8	1.0	2.4	-0.7	-1.8	-0.5	1.4
Italy	-2.4	-1.6	-2.8	-4.1	-3.4	-3.4	-3.3
Luxemburg	4.0	2.9	4.1	5.2	1.7	0.9	-0.5
Netherlands	-1.5	-0.8	-0.3	-1.3	-1.9	-2.1	-0.9
Austria	-2.4	-2.7	-2.8	-0.3	-0.3	-1.0	-0.8
Portugal	-3.4	-3.5	-4.5	-5.5	-3.5	-2.5	-2.7
Finland	0.4	0.6	5.3	4.8	4.3	3.0	2.5
Euro area	**-2.0**	**-1.5**	**-1.9**	**-2.6**	**-2.8**	**-2.8**	**-2.6**
General Government debt							
Euro area	**73.0**	**71.7**	**69.2**	**68.3**	**68.1**	**69.3**	**69.8**

Source: European Commission, AMECO database

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Recognizing the necessity of reforming the Pact and accepting a part of proposals listed in literature, the reform was carried out in 2005 without changing quantitative limitations from the "original" Pact, but changing the flexibility of definitions and implementation, which was one of the main objections of the "original" Pact. The reform encompassed a set of changes regarding preventive and corrective measures of the Pact (Morris, Ongena, and Schuknecht, 2006, pages 19-21).

The most important changes regarding the preventive part of the Pact are as follows:

- Defining midterm budgetary objective, depending on macroeconomic circumstances;
- Adjusting to midterm objective;
- Taking into consideration structural changes during assessment of the efforts made by states in order to implement recommendations, and so on.

The most important changes regarding the corrective part of the Pact are as follows:

- More flexible defining of the "serious fall of economic activity" and the reason for not implementing procedures in case of excessive deficit;
- Specifying the role of "other relevant factors";
- Extending deadlines for the procedure of excessive deficit:
- Putting the focus on debt and sustainability, and other.

The Pact reformed in such way was expected to ensure the pursuit of a sustainable fiscal policy and to replace the former rigidity with flexibility in the way of respecting specific circumstances of individual member states where fiscal rule is being implemented. As Benoi and Pisabi–Ferry (2005) noticed, from the implementation of reformed fiscal rule is expected to reconcile the request for long term sustainability and short term stability, to maintain stability of public finances without excessive discretion of the fiscal policy, and to accelerate reforms which would encourage economic growth.

However, due to the Great economic crisis in 2007, many countries were forced to implement various measures and activities aimed at stabilizing the fiscal sector and support economic activity because of insufficient aggregate demand arising as a result of negative effects caused by the crisis, what was certainly the case with the EU member states. The abovementioned activities had a negative influence on fiscal parameters of the EU member states, on the formation of high budgetary deficit, increase of public consumption, as well as deterioration of the public debt/GDP ratio, as can be seen in Figure 2.

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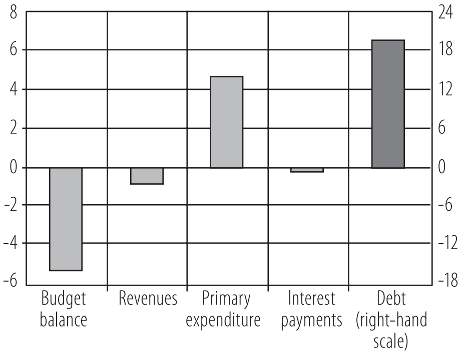
Figure 2: Development of the fiscal indicators in the period of crisis 2007-2010 (% GDP)



Source: Schuknecht, Moutot, Rother and Jurgen, 2011; page 12.

The reform conducted in 2005 failed to provide the required level of the fiscal discipline within the EU[3], a package of six regulations (Six-Pack) entered into force in December 2011 and it involves the implementation of five regulations and one directive to empower the Pact. The package defines quantitatively the significant deviation from a mid-term objective or adjustment towards achieving mentioned objective, operationalizes the debt criterion, introduces a reverse qualified majority voting for the most part of sanctions, which means that the proposal is adopted by the Council, provided that the qualified majority (at least 255 of total 345) is not against it.

The Six-Pack encompasses a reform of the preventive and corrective elements, specifies new minimal requirements for the national budget framework, a new macroeconomic imbalance procedure, not only the fiscal surveillance as before the reform, a stronger enforcement mechanism due to new financial sanctions, and so on (European Central Bank, 2012).

Besides that, the European Commission suggested, two additional regulations for empowering surveillance within the euro area in November 2012. A package of two regulations (Two-Pack) which entered into force on 30 May 2013 aims to strengthen the preventive aspect of the Pact as it implies that proposals of the budget plans, progress related to the procedures for excessive deficits, should be assessed and monitored by independent institutions. Actually, the first regulation refers to giving new competences to the Commission to evaluate and, if necessary, demand the revision of draft national budgetary plans to ensure the prevention of excessive deficits.

The other regulation includes new provisions to the Council and the Commission in order to strengthen surveillance over the macroeconomic, financial, fiscal situation in the euro area which threatens financial stability (European Commission, 2012).

[3] In the period 1990-2011, twelve states exceeded the permitted deficit level of 60%.

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The fear of spreading the debt crisis that could jeopardize stability within the euro area affected the need to further strengthen the economic union by empowering coordination of the national policies and by adopting the so-called "Fiscal Compact", which is an integral part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union – (TSCG). Many believe that it would represent an additional step towards the formation of the fiscal union. The fiscal pact was signed in March 2012 by all member states, except Great Britain and the Czech Republic, and it has a form of an interstate agreement implemented in parallel with the Six-Pack.

The need for the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union had arisen from the fact that the Pact, including the Six-Pack, had not been sufficient to ensure the necessary macroeconomic stability as the empowering of the national fiscal frameworks largely depends on the political will of the member states to implement the necessary fiscal rules. That was the main reason to draft the Treaty which will set the objective of strengthening fiscal discipline in the euro area through the improvement of the Pact. It consists of two main modules- the rule of a balanced budget, including the mechanism of automatic correction, which has to be implemented in national legislations, as well as the strengthening procedures for excessive deficits[4]. Finally, all reforms that have been implemented in relation to the Pact are shown in Figure 3:

[4] More details about the Fiscal pact and reforms of the Pact in general see: European Commission, 2013; European Central Bank, 2012; Institute for International and European Affairs, 2012.

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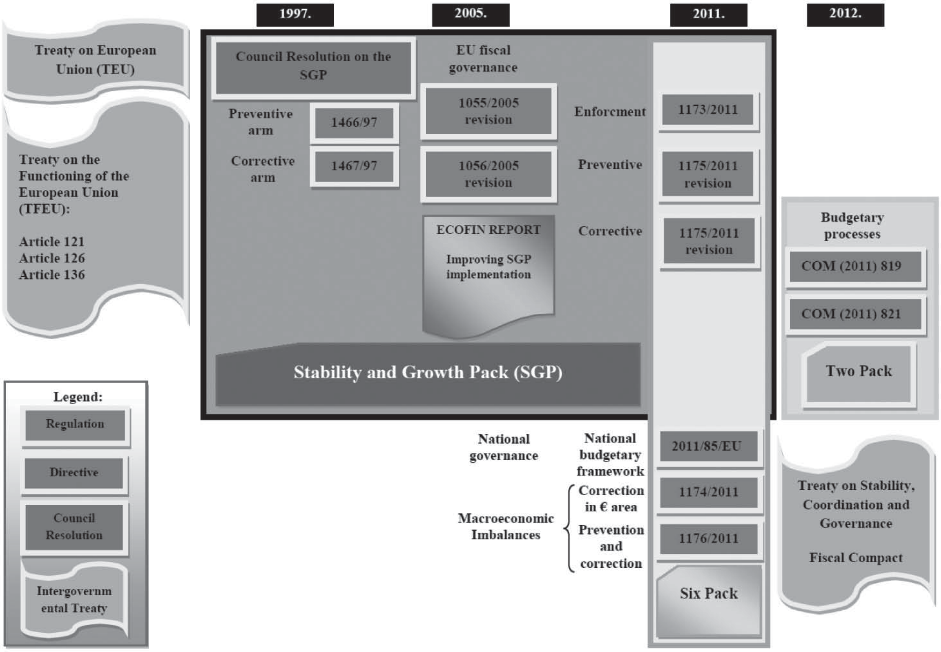
Figure 3: Display of the reforms of Stability and Growth Pact



Source: Reformulated based on: European Commission, 2013; page 22

Conclusion

The most important instrument of economic policy within the EMU members is the fiscal policy, which is limited by the supranational fiscal rules contained in the Maastricht Treaty and the Stability and Growth Pact, consisting of defining excessive deficits, determining preventive measures to avoid excessive deficits, and corrective measures or procedures in case of excessive deficits. Deterioration of fiscal indicators, rigidity and insufficient flexibility and equability, and a lack of needed attention regarding specific circumstances in some member states generated the need to reform the Pact in 2005 in part of its preventive and corrective measures.

The pre-crisis mechanism for the fiscal policy coordination failed to maintain fiscal discipline, ensure sufficient fiscal space, and/or provide automatic stabilizers operations in crisis conditions, and it was not strict enough and therefore conducive to being respected by the member states. Preventive measures, namely

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the Early Warning System, short term monitoring, and procedures in case of excessive deficits also did not bring expected results.

The abovementioned induced the need for a new Pact reform, which was followed by the adoption of the Six-Pack, Two-Pack, as well as the Fiscal Pact, which represents the integral element of the Treaty on Stability, Coordination and Governance. All listed reforms related to fiscal policy within the EMU are steps closer to the fiscal union formation.

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