CENTRE FOR EUROPEAN REFORM
policy brief

A pact for stability and growth

By Katinka Barysch

★ The stability pact is too important to be subjected to a quick fix. EU governments should start debating a thorough overhaul.

★ Under a reformed pact, countries with low levels of public debt should be allowed to borrow – and not only for investment.

★ Any loosening of the pact's rules should be accompanied by better budgetary surveillance and a more credible enforcement mechanism.

The stability and growth pact – the EU's fiscal rule book – is in tatters. Two eurozone countries, Germany and Portugal, are already in breach of the pact, having exceeded the 3 per cent of GDP limit for budget deficits. The French deficit is hovering around 3 per cent, and the Italian is not far behind. Moreover, some eurozone countries are ignoring the pact's other key rule, namely that they should balance their budgets by 2004. The Council of EU finance ministers (Ecofin) has launched 'excessive deficit procedures' against Germany and Portugal and they could eventually incur fines of up to 0.5 per cent of their GDP (see box page five). However, with most of the larger eurozone countries now close to or above the 3 per cent limit, there will be little political pressure for strict enforcement.

The stability and growth pact ensures neither stability nor growth. It has encouraged fiscal prudence in some countries, but little more than political defiance and creative accounting in others. It could now hamper Europe's economic recovery. So should the EU just scrap it? The answer is no.

The rationale for EU fiscal rules is as valid today as in 1997, when the pact was drawn up. If countries share a common currency, they should not and cannot be indifferent to each others' fiscal policies. Profligate public spending in one eurozone country could push up inflation and force the European Central Bank (ECB) to keep interest rates higher than they would otherwise be. Even more worrying is the prospect of a eurozone country piling up so much debt that it risks default. Although the EU treaty contains a 'no bail-out' clause, it is not clear whether the ECB and other EU countries could stand by and watch one of the eurozone governments go bust. Even if there is no direct intervention, the ECB could have second thoughts about a planned rate hike if that would push a eurozone country into default.

Moreover, Europe needs some kind of fiscal policy co-ordination to achieve the right mix of budgetary and monetary policies. Arguably, the real guardian of the stability and growth pact is neither the Commission nor Ecofin, but the ECB. The Bank clearly worries about growing budget deficits in Germany, France and elsewhere. In its monthly reports, the ECB has repeatedly chided European governments for not tightening their budgets. To drive its point home, it left interest rates unchanged throughout most of 2002, despite growing evidence that eurozone growth was slowing. With a fiscal framework that works badly and a central bank that fears appearing too soft, Europe risks a damaging mismatch between high interest rates and lax budget expenditure.

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The EU therefore needs fiscal rules that are flexible enough to allow governments to react to economic trouble but strict enough to ensure the sustainability of public finances. Two changes to the pact have been widely advocated by economists and policy-makers across Europe.

First, the EU should differentiate between budget deficits caused by overspending and those caused by changes in the economic cycle. Second, the EU should allow governments to borrow money for investment (the golden rule). These changes also form the backbone of a recent reform proposal from the European Commission. But although they look like an easy and quick solution to current policy dilemmas, they do not amount to a satisfactory reform of the EU's fiscal framework.

Keynes versus the stability pact

A shift from headline deficits to cyclically adjusted ones is mainly advocated by those who fear that the stability pact could strangle eurozone growth. With its deficit already above 3 per cent, Germany cannot boost public spending even though its economy is stagnating. The proponents of reform therefore want budget numbers stripped of those components that result from changes in economic activity, rather than government policy. Economists refer to these components as automatic fiscal stabilisers: if economic growth slows, the government automatically collects less tax and spends more on unemployment benefits. The resulting rise in the budget deficit can help to stimulate a sluggish economy. A stronger focus on cyclically adjusted budget figures would be a useful starting point for reform. But it is not a panacea.

First, budget trouble in Germany and elsewhere is not the result of the stability pact. In theory, the pact requires EU countries to balance their books or run surpluses in times of normal growth. When growth slows, governments should have enough leeway to let automatic fiscal stabilisers operate without breaching the pact's 3 per cent limit. Most EU governments have followed this rule. Despite the economic slowdown, seven out of 12 eurozone governments maintained balanced budgets or surpluses in 2001. However, some countries – most notably Germany, France and Italy – failed to consolidate their budgets during the years of strong growth. When growth slowed in 2001, their budget deficits were already close to the 3 per cent limit.

Second, even if the EU redefined the stability pact's 3 per cent limit in cyclically adjusted terms, Germany and others would not necessarily boost spending to reflate their economies. Even when stripped of cyclical components, Germany's budget deficit amounts to more than 3 per cent of GDP, according to Commission estimates. France's deficit looks little better. Furthermore, the assumption that only the stability pact prevents EU governments from rushing into large-scale Keynesian demand management is questionable. Both Germany and France have a long tradition of prudent fiscal policies. And both know that they need to put their public finances in order irrespective of EU rules.

Finally, it is fiendishly difficult to measure cyclically adjusted deficits. For this, the EU needs to calculate how tax revenue and spending react to economic swings in each particular country and whether economic output is above or below its potential (economists refer to this as the output gap). To answer these questions, the EU makes a host of economic assumptions that cannot easily be verified. As a result, estimates of cyclically adjusted budget figures vary widely. For example, the European Commission calculates that France had a small surplus in its cyclically adjusted budget in 2001 while OECD calculations show a deficit of 0.8 per cent of GDP. The EU has already made much progress towards agreeing a framework for calculating cyclically adjusted deficits. Nevertheless, these calculations are prone to so much statistical uncertainty that they are ill-suited to being a short-term yardstick for fiscal surveillance. This is why the European Commission, in its recent reform proposal, has suggested a shift to cyclically adjusted deficits only for medium-term fiscal targets, but not for the 3 per cent limit that is the cornerstone of the EU's sanction mechanism.

A golden rule for European growth?

Many economists would still question the pact's balanced-budget rule, even if it were applied more loosely over the business cycle. Why, they ask, should governments not be allowed to borrow money for growth-boosting public investments? Some (although not all) public investments will create budget revenue in the future. This could be used to repay the debt with which it was financed. Borrowing for investment also makes sense in terms of inter-generational fairness: Government spending on roads and schools benefits future generations, so why should it be financed entirely by current taxpayers?

Many countries have successfully applied such a 'golden rule' to their public finances in the past, including Germany in the post-war years and, more recently, the UK. But it is questionable whether the EU could or should adopt the golden rule as part of its budgetary framework. First, there is no clear evidence that the stability pact prevents governments from investing. It is up to each member-state to decide how much it wants to spend on consumption and investment. It just needs to make sure it raises enough tax to pay for

it. Public investment is very high in some countries, such as Finland and the Netherlands, that have successfully managed their finances in line with EU rules. Meanwhile, Britain and Denmark – both outside the eurozone – have some of the lowest shares of public investment in the EU.

Second, economists disagree about what kind of public spending constitutes investment and what should be booked under current expenditure. Building a new school or university is obviously an investment in the future. But what about teachers' salaries? At the national level, finance ministers can use discretion. But the EU would need clear definitions and enforceable rules to decide which borrowing is allowed and which is not. Given current budget woes, the EU countries would be tempted to draw up a rather long list of exemptions. The result would be either political deadlock or a perforated stability pact.

And yet, the current requirement that all countries need to balance their books is difficult to justify in economic terms. If governments are not allowed to borrow, their public debt will sooner or later converge towards zero. This makes sense for some countries, but not for others. Most EU countries have rapidly ageing populations and expensive pension systems that are financed out of tax receipts. Most already spend 15 to 20 per cent of their GDP on pensions and healthcare. Unless there is radical reform, age-related spending will rise by up to 8 to 10 percentage points of GDP over the next 40 years in countries such as Finland, Spain and the Netherlands. For these countries, the current balanced-budget rule may not be ambitious enough; they may well have to start running budget surpluses now to avoid a fiscal crunch in the future.

Most of the accession countries from Central and Eastern Europe face similar problems of ageing populations and low birth rates. They, too, will struggle to put their pension systems on a sustainable footing. But at the same time, they require massive public investment to bring their infrastructure up to scratch and update their education systems. Without these investments, future growth will suffer and catch-up with the West will be painfully slow.

A blueprint for reform

The EU's fiscal rules are too important to be subjected to a quick fix. A thorough overhaul is required. However, not all EU policy-makers are convinced there is a case for reform. Some fear that re-writing the pact under pressure could undermine confidence in the euro. However, by clinging to the letter of the pact while ignoring its spirit, the eurozone governments have already deprived it of all credibility. A thorough overhaul would do more to underpin the health of the single currency than political squabbles and creative accounting. Others are against reforms that would require a change to the Maastricht treaty. But with the health of the eurozone economy at stake, the EU should not be deterred by legal hurdles. It could debate new fiscal rules in the framework of the European Convention.

The most important obstacle to reform, however, is political. While the eurozone's smaller member-states have reformed their budgets to meet Maastricht rules, the larger ones have continued to spend rather freely. Why, the smalls ask, should we let Germany, France and Italy off the hook? However, the eurozone countries should not let political pride cloud economic realities. They share a common currency, a common interest rate and a common external account. They are closely intertwined through trade and investment links. They should regard the stability and prosperity of the eurozone economy as a common good.

EU heads of states and their finance ministers should use their next summit to agree on a number of principles for reform. They should then ask a panel of economic experts to work out the details of how these could best be put into practice. A reformed pact for stability and growth could have the following ingredients:

★ Focus on debt, not deficits

The stability pact's focus on current budget deficits rather than sustainable debt levels is in many ways a historical coincidence. Sustainable debt levels were at the centre of attention when the EU countries readied themselves for economic and monetary union. But the Maastricht threshold of 60 per cent would have stopped countries such as Belgium and Italy from joining because their debt levels exceeded 100 per cent of GDP. Another measure of fiscal rectitude was required. While reducing debt levels is a long and arduous task, budget deficits can be squeezed in the short term. Therefore, the EU focused more on the 3 per cent deficit criterion for euro entry than the debt criterion. The stability pact wrongly maintained this focus. This should be rectified.

Headline numbers for public debt reveal little about a country's long-term financial position. A better measure of national wealth would take into account state assets, such as publicly owned companies or state holdings of private-sector debt, as well as future pensions liabilities (see table page six). However, EU countries are only just starting to make calculations of this kind. For the time being, therefore, the EU cannot base its fiscal rules on such uncertain parameters. The EU should concentrate on improving available debt figures, while initiating a discussion on which measures of public debt are most appropriate.

★ Allow low-debt countries to borrow

If the EU focuses more on the sustainability of debt, it can no longer justify the rule that countries, even those with low debt, are not allowed to borrow. The only good reason for this one-size-fits-all rule is that it is simple and easy to understand. The EU should not shy away from a more differentiated system, especially in the light of enlargement. The Commission has suggested a formula under which some countries would be allowed to run small temporary or permanent budget deficits, depending on their debt levels. But they would still have to prove that the borrowed money went towards reforms with clear 'economic and budgetary benefits'. This formula is too complicated and too controversial – it would make the Commission or Ecofin responsible for judging which kind of national investment is economically beneficial.

A simpler rule would be to ask only highly-indebted countries to run balanced budgets or surpluses. Countries with debt levels of below 60 per cent of GDP would be allowed to borrow up to 3 per cent of their GDP each year and those with debt below, say, 40 per cent could borrow up to 5 per cent. It should be up to national governments to decide whether they want to follow the golden rule of borrowing only for investment. The fact that low debt levels would be 'rewarded' with more fiscal leeway may give eurozone members an incentive to invest the money wisely. Since the UK and most of the accession countries have debt levels below 40 per cent of GDP, they would be the main beneficiaries of this reform.

★ A pact for good and bad times

One of the main flaws of the stability pact is that it does not provide sufficient incentives for governments to save during good times. In theory, it requires all countries to run balanced budgets or surpluses in times of normal growth. In practice, it only starts to bite when growth slows and budget deficits hit the 3 per cent ceiling. The EU needs to think about ways to make the pact work in a more symmetric way. If a decrease in debt was rewarded with more fiscal freedom in the future, eurozone countries would have an incentive to tighten the budget and pay off debt during good times. But this incentive may not be strong enough to constrain profligate policy-makers.

This is not an EU-specific problem: left to their own devices, politicians tend to exhibit a bias towards fiscal expansionism, especially around election time. Many countries around the world have therefore put fiscal rules in place. The UK's medium-term fiscal framework is one example, although it still allows the government to break its own rules. The EU has the unique opportunity to use its Brussels-based bureaucracy and the peer pressure exerted in Ecofin to enforce fiscal rules. The EU should think about extending its system of warnings and sanctions to countries that fail to stick to their fiscal promises during good times.

★ Better forward planning

The basis of a more symmetric stability pact would have to be an improved process of budget planning and supervision. At the end of each year, the member-states submit updated fiscal plans – called stability programmes – for peer review in Ecofin. In theory, Ecofin checks whether member-states subsequently comply with their programmes. In practice, the stability programmes are of limited value for fiscal surveillance, partly because their quality varies from country to country. Although the EU drew up stricter rules for the programmes in 2001, some still do not include detailed projections for revenue and expenditure or comply with EU rules for budgetary accounting (called ESA 95).

All member-states should include detailed spending forecasts and planned tax changes in their programmes, as well as contingency plans in case economic conditions turn out better or worse than planned. They should draw up their stability programmes in parallel with their national budgets. Timely, accurate and credible stability programmes would have a number of advantages. First, they would provide a better basis for fiscal surveillance during times of growth. Second, they would allow the ECB to form a better idea of what the eurozone's overall fiscal stance would look like under different growth scenarios – a precondition for a better policy mix in the eurozone. And third, if governments agreed their fiscal plans with the EU and their national parliaments at the same time, EU fiscal supervision would be less politically controversial. At present, national budgets and EU stability programmes do not in all cases coincide. This may force the EU to reprimand a government for implementing a budget that has been passed by a democratically elected parliament.

★ Enforcement that bites

Both Germany and France are likely to exceed the 3 per cent limit for budget deficits again in 2003. Yet, few observers expect them to face financial fines for their repeated transgression. The EU's sanctions regime is tough – repeat offenders face fines of up to 0.5 per cent of their GDP – but it is based on political discretion. In the EU's system of fiscal surveillance, finance ministers are both the perpetrators and the judges. Some economists have suggested that the decision about sanctions should be moved from Ecofin to an independent body,

such as the Commission or the European Court of Justice. But this does not seem a viable alternative for the time being. The Commission lacks legitimacy and the Court's procedures are too slow.

Nevertheless, the EU should match any loosening of the pact with stricter enforcement. The Commission – while not the ultimate judge – plays a valuable role as policeman in the current system. It is in a good position to spot budget trouble early on, and should be allowed to issue warnings directly to individual governments. But for the Commission to play its role effectively, it needs more resources: at present only a handful of economists in Brussels follow budget developments across the EU. This would be even more important if the EU moved to cyclically adjusted budget deficits, or adopted some kind of golden rule for borrowing. In those cases, a reinforced Commission department should be given the final say in statistical disputes. Moreover, after enlargement Ecofin will contain more finance ministers from countries that have not (yet) adopted the euro. The responsibility for eurozone budgetary surveillance and sanctions should therefore move from Ecofin to the Euro group.

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The EU's fiscal rules

The stability and growth pact: The stability and growth pact, adopted in 1997, enshrines the member-states' political commitment to good fiscal housekeeping. This is defined as 1) budgets must be close to balance or in surplus over the medium-term; 2) in any given year, the budget deficit must not exceed 3 per cent of GDP. But the pact is only one part of the EU's fiscal rulebook; it is complemented by a process of multilateral budgetary surveillance and a sanctions mechanism for countries that breach the pact. EU countries that have not adopted the euro follow the same rules but are not subject to sanctions.

Budget surveillance: At the end of each year, the EU members submit updated fiscal plans to the European Commission, called stability programmes (or convergence programmes for EU countries that have not adopted the euro). The Commission makes a judgement on whether these are credible and consistent, and whether they are in line with the EU's 'broad economic policy guidelines' (BEPGs), which contain the full set of EU policy objectives, not only for fiscal policy but also for employment and economic reform. On the basis of the Commission's assessment, Ecofin issues an opinion and it can address recommendations to individual member-states. In 2001, for example, Ecofin reprimanded Ireland because its expansionary fiscal plans were out of line with the BEPGs. Since Ireland was not at risk of breaching the stability pact's 3 per cent limit (in fact, its state finances were in surplus), the reprimand had no legal force.

Ecofin, supported by the Commission, also monitors the implementation of the stability programmes. The Commission draws up reports about budgetary developments in the member-states twice a year. If it foresees trouble – in particular if a country's budget deficit is heading towards the 3 per cent threshold – it recommends that Ecofin issues an early warning to the government concerned. Although both Germany and Portugal were getting close to the 3 per cent limit in 2002, Ecofin decided not to issue such a warning. It did issue a warning to France in early 2003.

The excessive deficit procedure: If the Commission, as part of its bi-annual reporting exercise, finds that a eurozone member has breached the 3 per cent limit, it recommends that Ecofin starts an 'excessive deficit procedure' (EDP). The procedure is only set in motion if Ecofin declares the deficit excessive with a two-thirds majority. It will not do so if the deficit results from a deep recession (defined as a fall in GDP of more than 2 per cent). Beyond that, Ecofin has discretion to let a country off the hook if it is in a mild recession (GDP falls by 0.75 to 2 per cent) or the deficit results from an 'unusual event outside the control of the member-state'. Ecofin launched EDPs against Portugal in 2002 and Germany in early 2003, after their previous year's budget deficit had turned out to be above 3 per cent of GDP.

Once Ecofin has decided that an excessive deficit exists, the country in question has four months to adopt budget measures designed to reduce the deficit to below 3 per cent the following year. If it does not, Ecofin can decide – after a series of recommendations and warnings over the following three months – to impose sanctions. The decision is not automatic. Sanctions consist of a non-interest bearing deposit of up to 0.5 per cent of the recalcitrant country's GDP. If the country still fails to reduce its deficit during the following two years, the deposit can be turned into a permanent fine.

Public spending, deficits and debt, in per cent of GDP, 2002

	Budget spending		Budget balance		Public debt	
	Total	Investment	Headline	Cycl. adjusted	Headline	Net debt*
Austria	50.3	1.2	-1.8	-1.6	63.2	253
Belgium	48.6	1.4	-0.1	0.2	105.6	311
Denmark	54.2	1.8	2.0	2.1	44.0	165
Germany	45.1	1.7	-3.7	-3.3	60.9	222
Finland	51.0	2.7	3.6	3.7	42.4	335
France	49.4	3.0	-3.0	-2.7	58.6	280
Greece	41.4	4.0	-1.3	-1.7	105.8	329
Ireland	33.5	4.3	-1.0	-1.4	35.3	302
Italy	45.3	2.0	-2.4	-1.8	110.3	174
Luxembourg	45.6	4.8	0.5	-	4.6	-
Netherlands	44.1	3.3	-0.8	-0.6	51.0	287
Portugal	40.6	4.2	-3.4	-3.0	42.4	222
Spain	39.0	3.5	0.0	-0.1	55.0	415
Sweden	56.4	2.6	1.4	1.3	53.8	297
UK	40.5	1.5	1.1	-0.6	38.5	102
GDP-weighted average	45.0	2.3	-1.9	-1.6	63.0	233

* 2001 estimates of government debt taking into account government claims on the private sector, unfunded future pension obligations and other age-related spending. Sources: European Commission; press reports; Danish finance ministry; European Economic Advisory Group.

Other euro-related publications from the Centre for European Reform

★ *The Lisbon Scorecard III* Working paper by Alasdair Murray, March 2003.
★ *The euro and prices* Policy brief by Katinka Barysch, February 2003.
★ *How to reform the ECB* Pamphlet by Jean-Paul Fitoussi & Jérôme Creel, October 2002.

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