POINT OF VIEW

How Should the Stability and

3 Three points of view on the future of Europe's fiscal pact

Consensus that the Stability and Growth Pact (SGP) will need some adjustment appears to be growing. The recent failure of the European Union's (EU's) Council of Economic and Financial Affairs (ECOFIN) to follow the pact's prescriptions for addressing excessive fiscal deficits in several member countries has only added to already urgent calls for reform. But how far should reform go? Should the pact be completely rewritten, as some have argued? Or is it basically sound, making the problem one of enforcement rather than structure? Below, *F&D* presents the views of two private sector economists—David Walton and Angel Ubide—and a political scientist—Mark Hallerberg.

1 Time for Radical Surgery

David Walton
Chief European Economist, Goldman Sachs

THE SGP was flawed from the start and needs to be reformed to provide the euro area with a durable fiscal framework built on solid economic foundations.

France and Germany may have breached the rules of the pact, but fiscal policy has not been conducted irresponsibly. The rise in the euro area's budget deficit in the past couple of years has been mostly due to the effects of the economic cycle. By allowing the automatic stabilizers to work in full, governments have helped cushion the downturn in economic activity rather than exacerbate it. Unlike the United States, France and Germany do not have "twin deficit" (fiscal and current account) problems. If the deficit limit of 3 percent of GDP had been strictly enforced, a much greater burden would have been placed on the European Central Bank to use monetary policy to support the economy. This would hardly have been sensible, given that interest rates are already at historic lows.

It is no good resurrecting the pact in its existing form. Without credible reforms, further breaches are inevitable. Other countries could invoke France and Germany as precedents.

Several flaws in the original design of the pact need to be addressed.

- By requiring each country to achieve cyclically adjusted budgets "close to balance or in surplus," the pact treats each country the same despite very different ratios of government debt to GDP across the euro area.
- The balanced budget rule implies a decline in debt ratios toward zero. This makes little economic sense and even less political sense. The rule takes no account of the fact that public investment can add to a country's assets as well as its debts.
- The pact is asymmetric: it does not make proper allowance for cyclical effects. Once the deficit breaches 3 percent of GDP, member states are expected to eliminate the "excessive deficit" the year after it is identified, with little regard for the stage of the economic cycle. Conversely, the pact is not forceful enough in requiring fiscal consolidation during good times.
- The sanctions mechanism lacks credibility. Sanctions are unlikely to be applied when they run against what governments regard as their sovereign decisions, particularly when deficits are the consequence of weakness in economic activity.

Need for a new pact

Thus, the time has come to create a new pact that takes account of the experience of the past couple of years. A new pact should be geared to the following six principles:

First, all member states should reaffirm the need to adhere to a fiscal framework that guarantees the long-run sustainability of public finances within the euro area while allowing fiscal policy to help smooth fluctuations in the business cycle.

Second, there needs to be a clear focus on what governments need to do to achieve debt sustainability over the medium term. The pact should recognize explicitly that the debt-to-GDP ratio is more important than the deficit-to-GDP ratio. The appropriate budgetary position will vary from country to country. Highly indebted countries should be required to balance their budgets or even to run surpluses to reduce their debt ratios at a satisfactory pace. In determining the appropriate path for public debt, policymakers should take account of the need for higher public investment in some countries (especially in many of the new member states) as well as future liabilities (in particular, because of aging populations).

Third, to avoid excessive adjustment costs in the face of negative shocks and insufficient adjustment in the face of

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positive shocks, policymakers should focus on cyclically adjusted budgets at all times. Breaches of the 3 percent of GDP limit should be permitted when they are due to cyclical factors. Such breaches would be temporary, as allowed under the treaty, and reversed once the economy recovers.

Fourth, to allow greater flexibility and avoid periodic suspensions of the pact in the face of recessions or protracted stagnation, policymakers should apply the rules over the economic cycle, not over one particular year.

Fifth, the surveillance procedure needs to be strengthened in each member state. Serious consideration should be given to the creation of independent watchdog institutions that report to the European Parliament and work with the European Commission to evaluate budgetary policies, given agreed-upon medium-term debt targets.

Sixth, the idea of fines should be renounced, except in extreme cases. Ultimately, the pact has to be a disciplining device working through peer pressure, not sanctions.

2 Just Reinforce the Pact

Angel Ubide
Director of Global Economics, Tudor Investment Corporation

FRANCE and Germany scored a Pyrrhic victory against the European Commission last November. ECOFIN's decision to suspend the SGP's excessive-deficit procedure against the two countries—which went against the Commission's recommendation—severely damaged the pact, and the political costs are already mounting. The economic costs will have to be paid in due course if fiscal discipline is not restored. Hence, the EU's fiscal policy framework—and, within it, a strengthened pact—is more necessary than ever.

The political costs of damaging the reputation of the SGP are reflected in smaller countries' increasing suspicion that the rules established by the EU cannot be relied upon. If the excessive-deficit procedure could be suspended, could that also happen in other areas, such as competition policy, state aid, or even central bank independence? How can newcomers be expected to meet the convergence criteria (covering fiscal deficits, public debt, inflation, and interest and exchange rates) for Economic and Monetary Union (EMU) if existing members are flouting the rules?

The economic costs of excessive deficits—what the Maastricht Treaty calls fiscal profligacy—have become even more relevant now than when the treaty was concluded. Potential output growth in Europe has declined in recent years—the day the baby boomers retire has come closer, and public debt ratios are increasing again. If these trends are not reversed, Europe risks economic warfare between pensioners and workers over the distribution of income.

Of course, fiscal policy discipline always appears more bearable in the future than in the present. Politicians are thus receptive to economists brandishing the SGP as a fiscal straitjacket and offering absolution for their recent rule breaking. But describing current deficit reduction as procyclical—that is, as forcing countries to reduce deficits during cyclical downturns—is simply wrong. Most forecasts for 2004 point to above-trend growth. When, if not now, should steps be taken to put government finances on a more sustainable basis?

How to save the pact

In my mind, the problem with the SGP is how it is applied, not how it is written. Hence, the opportunity should be seized to strengthen the procedures. Two main changes are necessary. First, the Commission should be given more power as the supreme enforcer of the Maastricht Treaty and the SGP. Second, incentives for fiscal discipline should be strengthened by creating a system that exacts a political cost for noncompliance.

The first change is necessary because significant errors in budget forecasting are at the heart of the recent conflict. The excessive-deficit procedure is anchored in the expectation that countries will undertake measures to reduce the cyclically adjusted deficit to agreed-upon levels. But if budget forecasts are inaccurate and must be revised every other month, the procedure becomes unenforceable. Indeed, recent experience shows that, even within the same year, deficit forecast errors were close to 1 percent of GDP. No wonder the German authorities claimed they had honored their commitments: They had implemented the measures that a few months before were supposed to deliver the expected reduction in the cyclically adjusted balance!

To improve the quality of fiscal forecasts, the Commission must be given adequate resources to generate its own forecasts and fund independent national budget agencies that are monitoring budget developments—including debt issuance. Moreover, an early warning system should be developed to detect forecast errors before it is too late, perhaps by establishing confidence intervals around the baseline forecasts.

The Commission could issue early warnings whenever the lower end of the confidence band indicated a certain probability—say, 30 percent—that the deficit would be higher than 3 percent five quarters ahead.

The second change is needed because peer review has failed to prevent procyclical fiscal policies during upswings. As a result, financial sanctions arrive too late in the process, typically during the downturn, when fiscal consolidation is seen to perpetuate procyclical policy. Thus, prevention is paramount to ensure that countries have room for cyclical increases in nominal deficits during downturns.

Politicians are little impressed by financial sanctions that must be borne by the taxpayer. Sanctions should therefore create political rather than economic costs for noncompliance. This could be achieved if governments—in the context of the multiyear fiscal planning process—had to testify before their own parliaments following a negative report from the Commission. Governments should be required to explain the reasons for the slippages and lay out remedial measures.

Debt sustainability requiring both fiscal consolidation and structural reform to increase potential growth is the raison d'être of the Maastricht Treaty provision on excessive deficits. However, the political cycle is too short to trust governments with implementing proposed structural reforms. There is thus no trade-off between fiscal consolidation now and structural reform later. The SGP, if reformed along the lines suggested here, would raise incentives for structural reform while preserving existing incentives for fiscal consolidation.

3 Don't Touch It

Mark Hallerberg
University of Pittsburgh

THE SGP treats all states the same without regard to their underlying fiscal institutions. There are certainly sound reasons for this design. Yet differences at the domestic level mean that the impact of the SGP differs across countries. To understand why, consider how European governments control the budget process. The political economy literature is replete with discussions of what is known as the "rules versus discretion" debate. Is it better policy to give an institution discretion to reach a macroeconomic goal, or is it better to prescribe exact rules?

Much of the debate focuses on central banking, but the debate is just as relevant for the design of fiscal institutions. European countries, in practice, have used different, and predictable, mixes of rules and discretion in their efforts to maintain fiscal discipline. Some write detailed fiscal targets that they embed in coalition agreements. These amount to fiscal contracts among the parties in power. The multiyear agreements are meant to last as long as the government is in office. Other countries traditionally grant great discretion to a finance minister to set fiscal policy.

It is fairly easy to differentiate between the two types of fiscal governance in practice. Fiscal contracts arise under coalition governments in which political parties have competing policy priorities and expect to face each other in elections (Finland, Netherlands). Strong finance ministers emerge in systems where there is only one party in government (United Kingdom) or where the parties in government share similar policy views and usually run together in elections (France).

If states are classified according to this framework and the economic downturn in the early 1990s is compared with economic weakness today, a pattern emerges. It is striking that fiscal contract countries have tighter fiscal discipline than they did a decade ago. In contrast, states with strong finance ministers are not performing worse, but neither are they performing better. This evidence suggests that the SGP has had a discernible impact only in contract states. The explanation lies in the domestic sources of failure to maintain fiscal discipline in the two types of states. In the first case, one or more parties break the contract. In the second case, the finance minister cannot rein in spending or raise taxes effectively.

A fiscal pact that seeks to reinforce domestic institutions will need to be sensitive to failures under both types of fiscal governance.

A fiscal pact that seeks to reinforce domestic institutions will need to be sensitive to failures under both types of fiscal governance. The goal in the first case should be to strengthen the durability of the domestic contract. By enabling partners to monitor one another effectively and to identify clearly a contract violation, the SGP does just that. Its annual evaluations provide additional scrutiny of the budget in countries with fiscal contracts. It also provides clear goals for coalition partners and the public to judge the government's performance. In contrast, in states that delegate fiscal powers to a strong finance minister, the goal should be to strengthen his or her position. How this can be done in practice is less clear. There is a hope that pressure from Brussels would reinforce the position of finance ministers in domestic budget negotiations. But it seems unrealistic to expect private beratings at ECOFIN meetings to strengthen a finance minister's position at home. A weak finance minister may look even weaker in the eyes of his or her colleagues and the public if Brussels is seen dictating policy decisions.

The reality is that many of the established EU countries have coalition governments with fiscal contracts in place. The SGP has worked well by reinforcing fiscal discipline in these countries. Moreover, such contracts would also benefit most of the new EU members. This suggests that the SGP will become more effective once the new members join EMU. Over the medium term, therefore, the pact is perhaps better left untouched. If reform is attempted, however, it should take into account the possible effect on countries' domestic fiscal institutions. ■