What stability pact for Europe?

Par Hugo de Sousa

The current situation

The current economic situation in Europe is worrying. GDP growth for next year has been revised downwards and unemployment has been growing in some countries. The average growth rate estimated for this year is 0.8% and 1.8% in 2003. Moreover, four countries (Germany, France, Italy, Portugal) are facing difficulties keeping their budget deficits below the three percent ceiling and some have even surpassed it (Germany and Portugal). According to forecasts, Germany is likely to have 3.4% deficit next year, Portugal 2.4%, whilst France and Italy are likely to see a rise in their deficits (2.9% for France next year while Italy would reach this value in 2004). However, the current economic downturn should not become the excuse for the elimination or the softening of the stability and growth pact. The pact has some inefficiencies which led to some inconsistency in economic policy management in the Euroland but that should not imply that the stability and growth pact serves no purpose. Indeed, it is essential to have a rule for the co-ordination and mutual surveillance of budgetary policies in the EMU. Moreover, various studies point to the excessive burden that will be imposed on public spending from 2015 onwards, due to population ageing, which makes this one of the most important issues for the future. These studies point to an increase of between 4%-8% in public spend just to finance pensions due to population ageing. According to a recent UN study, developed countries are likely to lose 15 million inhabitants, a situation which will naturally imply a stronger effort by the State to cope with this pressure. Therefore, it is essential that countries pursue sound fiscal and budgetary policies in the years to come which imply expansionary policies during economic downturns and restrictive polices during an economic boom period. Hence, balanced budgets in the medium term are essential. If not, countries will be faced with no other option but tax rises to cope with the extra expenditure that will be needed. Moreover, one of the purposes of the stability and growth pact was to avoid any policy conflict between monetary and fiscal policies. It aimed at preventing countries from running higher than desirable budget deficits which they might be tempted to do in a monetary union as the effects resulting from such a deficit would spread around the entire MU thereby diluting its negative effects in the domestic country. Furthermore, it was meant to ensure some economic policy co-ordination and together with the broad economic policy guidelines provides the only economic policy co-ordination in the EMU.

Therefore, no doubts should subsist today regarding the need to have a balanced budget and henceforth fiscal sustainability over the long run within a monetary union. However, the pact always left open to countries the way to achieve the budget balance objective. It never distinguished between investment and consumption and moreover it never made the difference between good and bad spending. Another criticism often made to the stability and growth pact is its lack of flexibility whenever the business cycle changes. So, a country can theoretically be penalised if it breaks the 3% ceiling, both if it failed to cut current expenditure and if it became a victim of a hostile economic atmosphere implying a loss in revenues. It can obviously be argued that countries should make the necessary expenditure cuts during economic booms so that they might be better prepared to deal with an eventual economic recession once the business cycle changes. Nevertheless, the stability pact clearly does not take into account this argument, as it fails to present binding rules for the pursuing of anti-cyclical policies.

The recent events surrounding the pact

Hence, the events around the stability pact that have taken place in the last months are not surprising. It started at the informal meeting that took place at the beginning of September which had as main point the announcement by the European Commission that economic recovery in the EU was postponed for six months given that GDP growth had been reviewed downwards; more precisely meaning the EU would grow "marginally less than 1%" this year against the 1.4% forecast before. The Commissioner, Pedro Solbes, also recognised that this slow recovery would have an adverse impact on the consolidation of the deficit objective for this year, namely due to a predictable loss of revenues. He also sustained that on an analysis still to be done there was an element of nominal deficit and one of "structural deficit", structural deficit meaning corrected for cyclical fluctuations.

Not surprisingly, on the 24/09/02, the European Commission proposed that the balanced budget objective should be postponed until 2006, justifying its decision with the slowing down of the European economy. However, the Commission stressed that countries needed to present a quantified strategy concerning the reduction of the structural deficit. The countries in question, Portugal, Italy, France and Germany, needed to reduce their structural budget deficit by, at least, 0.5% per year. On the same day, the Commission adopted its report on the Portuguese public finances. This report was the first step towards the excessive deficit procedure (art. 104.3 of the Treaty) as the Portuguese deficit proved to be higher than expected, 4.1%. The report also said that the deviation from the original forecast target could only be partially attributed to the external economic situation but that "the size of the deficit was about equal to government investment expenditure". The ECOFIN council, based on the Commission report, urged Portugal to reduce its budget deficit by 2002 and on November, 6th, the Portuguese government announced it would freeze 50% of its spending in new acquisitions and current spending until the end of the year, in order to get back in line with the 3% budget deficit. This is a rather serious economic measure taken in a country that will grow, for the first time in the last 10 years, less than the EU average. Such a reduction is likely to have a negative effect on the growth potential of the country. Moreover, the Commission has recently adopted the same procedure regarding Germany as its deficit was officially recognised as being 3.8% of GDP and also launched an early warning against France as it is approaching the three percent ceiling. Germany facing unexpectedly low tax revenues is also embarking in a process of austerity measures such as a rise in taxes and spending cuts in various domains of its economy to see if it can reduce its deficit to below the limit. However, the French Finance Minister, Francis Mer, in the last informal Eurogroup meeting announced to his peers that France did not commit itself to lower the structural deficit by the 0.5% as the Commission had requested. Concerning the candidate countries, the Czech government said it will not take measures to reduce its budget deficit in order to reach the EMU criteria in due time. This lack of coherence between the policies taken by some Euro-zone countries, plus the Czech Republic, stresses the fact that a fast revision of the stability pact is needed. Therefore, a clarification on the mechanisms underlying the stability and growth pact is urgently needed.

Some views

Many have, therefore, been claiming for a revision of the rules governing the stability pact. In this respect, Collignon (2001) argued that " the stability pact is a device to overcome free riding, but it gives no guidance about the coherent policy mix…the present arrangements are a bricolage of odds and ends; they do not ensure a coherent and sustainable optimal policy mix". Jean Pisani-Ferry (2002) also questions the current framework of the stability and growth pact, namely its lack of short term flexibility: "…whether the design of the current one (SGP) provides the right incentives to national governments while achieving the right mix between short-term flexibility and long-term constraint". Buiter (2002) also confirms the view that "both the stability and growth pact and the broad economic policy guidelines currently in place are ill-designed to address the economic realities of countries that differ vastly from the current EU average as regards their expected future nominal GDP growth rates and their inherited stocks of environmental and public sector capital". Pascal Lamy, the EU trade Commissioner, also argued a revision of the stability pact and linked it to the entry of Great Britain in the EMU and the Commission President, in a controversial statement, also advocated the pact revision. Gros, on the other hand does not see much role for fiscal policy stabilization in the short run and claims that the stability pact should be tightened more and that it should be enforced in a more efficient manner.

Accordingly, there have been lately two main views as to how to overcome the current situation: one involves reformulating the current framework of the SGP, in line with the decisions that have already been taken by the Commission, e.g. structural deficit instead of nominal deficits. The other points to a fiscal policy centralisation (i.e.Wyplosz). The latter is something rather difficult to obtain as countries do not wish to relay any more sovereignty on this domain. Plus, having a fiscal policy framework determined solemnly by economic experts would pose some democratic legitimacy issues that should not be neglected. Therefore, and knowing that it is essential to have budgetary policy co-ordination within a monetary union, ways of improving the current SGP framework are essential and likely to be agreed upon in the current economic climate. This goes in line with the last proposal of the European Commission which I shall refer to later on.

In fact, the current difficult economic situation that Europe is facing provides the exact momentum to reflect further on this topic and to bring about a solution that would ensure a better short-term and long-term co-ordination of the budgetary policy in the Euro-zone. Indeed, the recent French-German unofficial proposal to include other criteria such as employment related issues, inflation, the national debt and the quality of future preparations (meaning, according to the FT, Nov. 5th, investment in research and development, and possibly in pensions) goes in the right direction, namely as to improve economic co-ordination in the Euro-zone, notably the policy mix, even tough inflation management should continue to be done solemnly by the ECB. Indeed, the current stability and growth pact is linked to monetary policy targets neglecting some important aspects of demand side economics such as investment. More co-ordination in employment policies, R&D investment and life-long learning is essential if Europe is to reach the Lisbon targets. The bottom line is that deficits should not be cut at the expense of public investment, although its components should be clearly defined.

Some proposals

Hence, what can be done to improve the current framework of the stability and growth pact and to make it more investment and growth oriented?

As mentioned before, the Commission has already taken an important step by allowing the structural deficit to be counted for, instead of the nominal one. The reform of the SGP should include other variables, such as a better definition of public spending, namely a distinction between investment expenditure, current expenditure and revenues, what should be attained in the short and in the long term, national debt levels, the use of anti-cyclical policies and clear binding rules, guarded by a more active Commission. Moreover, the pact should be an active economic policy co-ordination mechanism and should move alongside the Lisbon objectives. I shall now refer to each of these points separately:

- " The current SGP does not take into account the reasons that lead to a given deficit. Hence, a country that has a deficit caused by higher investment expenditure, let us say, due to an increased investment in infrastructures and/or R&D, will under the current framework be regarded in the same way as a country that breached the threshold due to a rise in current expenditure and/or due to the use pro-cyclical policies during an economic boom without the respective cuts in expenditure. Therefore, it is essential to distinguish good from bad spending. If European countries wish to stick to the Lisbon agenda (and the sustainable development strategy) and so make Europe the most dynamic and knowledge based economy by 2010, countries will need to make the necessary economic reforms and to invest more resources into areas such as research and development, just to give one example. It can be argued that private investment will play the biggest role in this process. But, even if some investment will be private investment, it is dubious to believe that the state won't have to make a greater effort to attain the Lisbon objectives. Henceforth that might lead to an increase in investment expenditure and accordingly to a rise in the budget deficit, contributing to a further deterioration of the public finances, if the current definition of the stability and growth pact prevails. Therefore the new SGP should identify clearly what are the expenditure types counting towards the final deficit value and at the same time give the necessary room for manoeuvre for member states to pursue investment and growth oriented policies. Therefore, investment in R&D, education and environment should be dealt with separately and the application of the golden rule of public finances could apply.
- " The new SGP should be focussed on a compromise between short and long run objectives. That would imply attaining a budget balance across the European countries within the medium run, but over the long run to focus more on the debt level. There must be a binding rule similar to the one existent in the deficit criteria but concerning the debt levels that would also have to be enforced. Namely, countries with high debt values should commit themselves to lower their debt at a constant pace every year so as to attain a sustainable value over the long run. Hence, some short term flexibility should be granted to countries if they would pursue economic growth targeted polices placing more emphasis on the long run, namely debt levels. If the European economy faces an unexpected slowdown of economic activity (and not only a serious recession), there should be a more flexible approach to the rules allowing countries to follow pro-investment policies (not discretionary tax cuts), especially if they have attained a balanced budget or are in surplus. A compromise between the short term and the long term objectives seems therefore essential.
- - " The new stability pact should clearly state that pro-cyclical policies should not be allowed and should consequently be sanctioned. That could include tax cuts in economic boom periods without the respective cuts in spending. The Commission should be given the formal power of starting actions against a country if it would find evidence that a particular country was undertaking policies that would violate the spirit of the new pact, namely pro-cyclical policies. A question that may rise

is whether the Commission should take actions even when the whole EMU area is not under threat due to a policy taken by a member state. This question was posed when the Commission started the procedures against Ireland that the Council adopted. Some claimed that the Council should not have adopted such a procedure on the grounds that stability in the EMU would not be affected as the Irish economy represents a minor part of it. Nonetheless, if it is true that initiating such a procedure should be carefully pondered as it can imply adverse and negative reactions, countries participating in a monetary union should be treated equally. Also important is to define a pro-cyclical policy. Here, again, an increase in expenditure in R&D during an economic boom, for example, should not be regarded as a pro-cyclical measure. On the contrary, discretionary tax cuts should.

- - " The new SGP should have clear and binding rules governing both the deficit value, the use of pro-cyclical policies and the debt value. Those are of extreme importance for two main reasons: firstly because they are more likely to bind the actions of members states (if enforcement is credible) and secondly because it improves the transparency of economic policy and therefore its credibility. The success of the Maastricht convergence criteria illustrates this point clearly, namely by the success it had on bringing down interest rates, budget deficits and debt levels in the 1990's. Moreover, member states should be aware that those rules would be enforced in case they would be breached. This implies that leaving the power of deciding to impose or not sanctions against the non-virtuous countries to the Council in the way it is currently, may not be adequate. Ideally, the Commission would propose to the Council either an early warning or an excessive deficit procedure and the Council would vote with QMV to reject the Commission recommendation, if it wished to do so. Therefore, the Commission proposal would automatically come into force if it weren't rejected by the Council.

In order to foster the development of the second pillar of the stability and growth pact, the one concerning growth, it is necessary to have improved co-ordination of economic policy, namely employment, investment, R&D and life-long learning. The stability and growth pact should have its growth pillar strengthened and that could imply further economic policy co-ordination plus a definition as to what should count as investment. That should be related to the Lisbon and Gothenburg objectives. It is very important that the stability and growth pact acts in a supportive way in the attainment of the Lisbon goals rather than a handicap. The creation of a European tax to fund the additional effort required due to enlargement (more investment in regional and cohesion policy) as well as to have the resources available to further invest in defence should be considered.

The Commission proposals were a great step ahead as to increase the transparency and the efficiency of the stability and growth pact. By attaching more importance to the debt values and by allowing countries that have reached balanced budgets to deviate from this once an economic downturn exists, the Commission recognises the importance of fiscal policy in the short run as an efficient economic tool. The Commission proposal to have further powers, namely at initiating the early warning system should be considered but there remain some doubts to its effectiveness. Something more effective could be to reverse the actual mechanism. Hence, instead of having the Commission recommendation approved by QMV by the Council, the Commission recommendation would automatically come into force if the Council would not reject it; also by QMV. They are proposals that make the pact more rigid and should provide a better mechanism for the sustainability of public finances over the long run. Nevertheless, they could have gone a little further, so as to include a better definition of what should be regarded as deficit (i.e. investments in line with the Lisbon strategy, defence investment, and so on). That could have helped to provide for a friendlier and investment oriented stability and growth pact and to make it a more effective mechanism of economic policy co-ordination as well as a tool along with the Lisbon and Gothenburg strategies.

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