



CENTRE FOR EUROPEAN REFORM

*policy brief*

# A pact for stability and growth

*By Katinka Barysch*

- ★ The stability and growth pact has lost all credibility and needs to change. Instead of attempting a quick fix under pressure, 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.
- ★ The EU should match any loosening of the pact's rules by establishing stricter budgetary surveillance and a more credible enforcement mechanism.

The stability and growth pact – the EU's fiscal rule book – is in tatters. The eurozone's largest countries, Germany and France, are in breach of the pact, having exceeded the 3 per cent of GDP limit for budget deficits in 2002 and 2003. They are likely to do so again in 2004, possibly alongside Portugal and Italy. The council of EU finance ministers (Ecofin) has launched 'excessive deficit procedures' against Germany, France and Portugal, and they could eventually incur fines of up to 0.5 per cent of their GDP (see box on page five). However, with most of the larger eurozone countries now in breach of the pact, Ecofin is unlikely to vote in favour of imposing sanctions.

As it stands, 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 threaten Europe's economic recovery by forcing Germany and others to tighten their budgets at a time when their economies are already in recession. So should the EU just scrap it? The answer is no.

The rationale for having common 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 questionable whether the ECB and other EU countries could stand by and watch one of the eurozone governments go bust. The ECB could have second thoughts about a planned interest rate hike, if that risked pushing 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 that growing budget deficits in Germany, France and elsewhere could push up inflation in the future. 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. And in the first half of 2003, worries about fiscal profligacy kept the ECB from cutting

rates more quickly. With fiscal rules that do not restrain governments and a central bank that fears appearing too soft, Europe risks a damaging mismatch between high interest rates and lax budget policies.

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. The stability and growth pact has failed to strike that balance – partly because its design is flawed, but also because some EU member-states have implemented it so badly. Properly interpreted, the pact consists of two rules. The first rule requires EU governments to run balanced budgets or surpluses over the medium term. The second rule says that if governments do slip into deficit, that deficit must not be larger than 3 per cent of GDP in any given year (a third rule, referring to total public debt, now gets little attention, see box for details). Since only the second rule comes with sanctions attached, it has moved into the spotlight. The trouble is: it does not work without the first one.

### Keynes versus the stability pact

This basic truth is sometimes overlooked by those who attack the pact for strangling economic growth. The pact's critics are right to highlight the link between public spending and economic growth. Government budgets help to smooth out economic activity, which is especially important in the eurozone, where countries no longer have their own interest rates for macro-economic management. When the economy slows, the government automatically collects fewer taxes and it spends more on unemployment benefits. The resulting rise in the budget deficit can give a welcome boost to economic activity. This is what economists mean when they talk about 'automatic fiscal stabilisers'.

However, these stabilisers should work in both directions. This is what the first rule of the stability pact says: when growth is strong, countries should tighten the purse strings and save for a rainy day. In the next downturn they should then have enough leeway to let the automatic fiscal stabilisers work without breaching the pact's second rule, namely the 3 per cent deficit limit.

Most member-states have stuck to both rules. But some – most notably Germany, France and Italy – failed to consolidate their budgets when the going was good. When growth slowed in 2001, their budget deficits were already close to the 3 per cent limit. However, to say it is their own fault that they are now in fiscal trouble is as true as it is irrelevant. The fact is that Germany's economy has not grown for three years while

France is also heading for recession. And although their budget deficits are already above the 3 per cent limit, both countries are planning tax cuts to revive their economies. This leaves the EU in a bind. Should it insist that Germany and France tighten their budgets, possibly pushing them deeper into recession? Or should the EU let them off the hook, perhaps by invoking an ill-defined clause that allows governments to run excessive deficits in 'special circumstances'? Or should the EU scrap the 3 per cent rule altogether and concentrate on the pact's first rule, which states that countries should balance their books in normal times?

### A golden rule for European growth?

Some economists, however, also question the pact's first rule. Why, they ask, should governments not be allowed to borrow money for growth-boosting public investments? The arguments in favour of such a 'golden rule' are convincing: some (although not all) public investments will create budget revenue in the future, which governments could then use to repay the debt with which the investment 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 a 'golden rule' to their public finances in the past, including Germany since 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, the stability pact does not prevent 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 countries such as Finland and the Netherlands that have successfully managed their finances in line with EU rules. On the other hand, Britain and Denmark, which are not bound by the stability pact, 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 re-classify too many

spending items as investment. The result would be either political deadlock or a perforated stability pact.

Still, the 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 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 update their infrastructure and education systems. Without these investments, future growth will suffer and catch-up with the West will be painfully slow.

### **Muddling through won't do**

Although the stability and growth pact is clearly in trouble, the EU seems unwilling or unable to change it. In June 2003, EU finance ministers adopted some modest reforms propagated by the European Commission. They pledged to pay more attention to the economic cycle when interpreting budget numbers. However, they will apply this only to the balanced budget rule, the one that does not bite. The 3 per cent limit for budget deficits will remain as binding as ever. As a result, the pact is now in a muddle, with one of its rules re-interpreted in cyclically adjusted terms and the other one unchanged. The Commission has also suggested a modified version of the 'golden rule', which would allow low-debt countries to borrow provided they spend the money on growth-boosting investments. Ecofin has neither rejected nor accepted that rule.

Not all EU policy-makers are convinced of the case for reform. Some fear that re-writing the pact under pressure could undermine confidence in the euro. However, the euro is going from strength to strength despite current budget woes. Meanwhile, by clinging to the letter of the pact while ignoring its spirit, the eurozone governments have already deprived it of all credibility. The main obstacle to a fast reform of

the pact is not economic but political. Germany, once the key proponent of the pact, is in a poor position to lead reform efforts. France, which has been blatant in its disregard for EU fiscal rules, is similarly ill-suited. Many of the eurozone's smaller member-states are vehemently opposed to reforms. After having squeezed their public finances to comply with the pact, they are now reluctant to let France, Germany and Italy off the hook.

### **A blueprint for reform**

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 government and their finance ministers should 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. To facilitate future reform, the member-states should not include the stability pact and the sanctions mechanism in the EU's new constitution, which is currently debated in Rome. The constitution should contain the principles of fiscal responsibility and sustainability, perhaps with a reference to future generations. It should not contain detailed rules of a pact that is already falling apart. 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 the primary concern 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 beginning to make calculations of this kind. The EU cannot base its fiscal rules on such uncertain parameters. It should concentrate on improving the 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 overall debt levels, 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. Only highly indebted countries should be required to run balanced budgets or surpluses. Countries with debt levels of below 60 per cent of GDP should be allowed to borrow up to 2 per cent of their GDP each year, and those with debt below, say, 40 per cent could borrow up to 4 per cent. Whether governments want to spend that money on investment (following a golden rule) or not should be for them to decide. Since the UK, Ireland 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 more symmetrically. 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 without facing sanctions. 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 EU can only make a more symmetrical stability pact work if it is based on an improved system 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. The EU drew up stricter rules for the programmes in 2001, and the member-states agreed on a (voluntary) code of conduct for budget statistics in 2003. Nevertheless, some countries neither include detailed projections for revenue and expenditure nor fully 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 2004. 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 miscreants and the judges. (Although countries that are in breach of the pact do not vote on their own sanctions, they can hope for a certain amount of sympathy from their peers.) Some economists have suggested that decisions on 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 at present. The Commission lacks legitimacy while 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. It should be allowed to issue warnings directly to individual governments, rather than having to rely on Ecofin to do this. 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. A reinforced Commission department should have 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, as foreseen by the European Union draft constitution.

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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; 3) total public debt must not be higher than 60 per cent of GDP. In June 2003, Ecofin agreed on a 're-interpretation' of the pact's first rule. EU countries will now seek to balance their budgets over the cycle. When economic growth is in line with medium-term trends, the budget should be balanced. If growth is slower, governments can let the automatic fiscal stabilisers play and run a nominal budget deficit (but only up to 3 per cent of GDP). If growth is stronger, they are, strictly speaking, required to run budget surpluses. Those countries that run structural (i.e. cyclically adjusted) budget deficits must reduce them by 0.5 percentage points of GDP each year until they reach balance.

The stability and growth 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', 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. Ecofin, supported by the Commission, also monitors the implementation of the stability programmes. The Commission draws up reports on 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 should issue an early warning to the government concerned.

**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). Ecofin first needs to establish whether the deficit in question is indeed 'excessive'. Ecofin will not launch an EDP if the country in question is in deep recession (defined as a fall in GDP of more than 2 per cent). Ecofin has discretion to act if the country 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' or 'exceptional circumstances'.

Once Ecofin has decided that an excessive deficit exists, the country in question has up to 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, as a percentage of GDP, 2002

|                    | Budget spending |            | Budget balance |                     | Public debt |           |
|--------------------|-----------------|------------|----------------|---------------------|-------------|-----------|
|                    | Total           | Investment | Headline       | Cyclically adjusted | Headline    | Net debt* |
| <b>Austria</b>     | 52.0            | 1.2        | -0.6           | -0.6                | 68.7        | 253       |
| <b>Belgium</b>     | 50.1            | 1.7        | 0.1            | 0.7                 | 105.3       | 311       |
| <b>Denmark</b>     | 54.9            | 1.7        | 2.0            | 1.9                 | 45.2        | 165       |
| <b>Germany</b>     | 48.6            | 1.6        | -3.6           | -3.3                | 60.8        | 222       |
| <b>Finland</b>     | 49.2            | 2.7        | 4.7            | 4.8                 | 42.7        | 335       |
| <b>France</b>      | 53.7            | 3.1        | -3.1           | -3.3                | 59.1        | 280       |
| <b>Greece</b>      | 47.7            | 3.8        | -1.2           | -1.8                | 104.9       | 329       |
| <b>Ireland</b>     | 33.7            | 4.4        | -0.3           | -0.9                | 33.3        | 302       |
| <b>Italy</b>       | 47.5            | 1.8        | -2.3           | -2.1                | 106.7       | 174       |
| <b>Luxembourg</b>  | 45.5            | 4.6        | 2.6            | 2.0                 | 5.3         | -         |
| <b>Netherlands</b> | 47.2            | 3.5        | -1.1           | -1.0                | 52.6        | 287       |
| <b>Portugal</b>    | 46.3            | 3.6        | -2.7           | -2.5                | 58.1        | 222       |
| <b>Spain</b>       | 39.6            | 3.3        | -0.1           | -0.4                | 54.0        | 415       |
| <b>Sweden</b>      | 58.2            | 3.3        | 1.3            | 0.9                 | 52.6        | 297       |
| <b>UK</b>          | 40.7            | 1.3        | -1.3           | -1.0                | 38.4        | 102       |
| <b>Average**</b>   | 47.4            | 2.2        | -1.9           | -1.8                | 62.7        | 233       |

\* 2001 estimates of government debt taking, into account government claims on the private sector, unfunded future pension obligations and other age-related spending. \*\* GDP weighted.

Sources: European Commission; press reports; Danish finance ministry; European Economic Advisory Group.

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