Stability Pact in Need of Reform?

Is the European Stability and Growth Pact in need of reform? Should it even be abandoned? The recent communication of the European Commission, tabled by Pedro Solbes, the Commissioner for monetary affairs, for consideration by the EU finance ministers takes up some of the critique raised in the past months' public debate while staying firm on the essence. The essence is: first, EU members must obey the limit for the public sector deficit of three per cent of GDP, except for the cases of a "severe economic downturn" or an "unusual event" outside the country's control; second, over the medium term they are committed to realising a budgetary position of "close to balance or in surplus" or, to put it differently, their structural deficit should (always) be zero.

Against the background of the present weak growth performance and high public sector deficits, expected in the current and the coming year for Germany (3.8/3.1%), Portugal (3.4/2.9%), and France (2.7/2.9%), harsh criticism of the Pact has been voiced by France, Italy, EU Commission President Romano Prodi (who described it as "stupid") and part of the academic community. Especially the three per cent boundary has been criticised as being ill-founded, rigid and harmful. As to the first criticism, it is certainly true that there is no scientific basis for a three per cent limit. The limit was a political decision, which was however not without foundation. Experience in the 1980s and early 1990s had shown that huge public sector deficits, of up to 12 per cent of GDP, had swelled public debt levels, led to a growing burden of interest payments, diminished budgetary flexibility, triggered inflation and raised doubts about the sustainability of fiscal policy – without yielding the growth benefits the deficit spending was supposed to create. At the same time, in view of the poor track record of discretionary policy coordination in the EU, EMU needed clear-cut and transparent rules for fiscal policy to give credibility to the new single money and to support the ECB's stability-oriented monetary policy.

The Stability Pact has served that purpose well and, by providing finance ministers with a strong argument to oppose domestic demands for higher expenditure, was instrumental in fiscal consolidation and in reducing the level of public debt: in 2002, in spite of slow GDP growth, eight of the twelve euro countries will attain a budget deficit of less than 1.5 per cent or a budget surplus. In addition to Germany, Portugal and France, only Italy (with 2.4 per cent) will record a deficit of more than 2 per cent. Nine EMU participants report debt levels of less than or close to 60 per cent whereas for Italy, Greece, and Belgium debt levels still exceed 100 per cent of GDP. Therefore the answer cannot be to change the rules but rather for the small group of poor performers to follow the successful example set by the great majority and to live up to their own commitments.

Are the rules too rigid? Obviously not. Their violators are not the innocent victims of an inflexible model of fiscal management. Countries which have done their homework in the prosperous years and have rolled back their deficits or even turned them into surpluses do not have to worry now about letting the "automatic stabilisers" work. The countries in trouble are those which in the past have neglected their structural deficits, counting on a persistently high GDP growth rate to solve their budgetary problems. Yet, is it not true that in the current economic situation the three per cent rule may still turn out to be harmful, given that past negligence? This view is based on the standard Keynesian argument according to which fiscal consolidation in a period of sluggish growth will (automatically) trigger a downward spiral. However, the argument overlooks the crucial negative confidence effects on economic activity that are likely to follow from the dissolution of a cornerstone of EMU. It is thus by no means certain that sticking to the Pact will be economically harmful while repealing it could produce economic benefits. The opposite might well be true.

Advocates of a revision generally shrink back from openly demanding a scrapping of the Pact and instead propose replacing it by a "better" one. According to the proposals made, a "better" Pact would allow the running of a cyclically adjusted (i.e. structural) deficit, it would focus on the growth of (cyclically adjusted) expenditures rather than on the deficit, it would concentrate on current spending and permit investment and military spending to be financed by debt instruments (modified "golden rule"), it would distinguish between "good" and "bad" deficits, or it would simply be interpreted and applied more "flexibly". What these proposals boil down to is either an outright loosening of fiscal discipline or the replacement of a clear and transparent rule by an ambiguous one (calculation of the cyclical adjustment, definition of investment) or, finally, the substitution of a rule-based system for wide political discretion.

Substituting discretion for rules is in fact what is behind many, if not most, of the proposals. In the eyes of both Commission President Prodi and the French-Italian tandem Chirac/Berlusconi the "inflexibility" of the present Pact is tantamount to their own limited influence on the definition of what is (politically) "right" or "wrong". However, that is just what constitutes the very charm of the Pact. In one point, the three are of the same opinion: "It does not suffice to have intelligence. We have it. One must also have the power to decide." (Prodi) Yet, who precisely should have that power is the point where the two sides disagree. With a view to the ongoing discussion in the Convention, Prodi wishes to strengthen the role of the Commission while Chirac and Berlusconi (and perhaps Schröder, too) aim at giving the Council a stronger position in the process of economic policy coordination.

As to the Commission, it has so far done a fair – though certainly not an excellent – job of defending the wording and the spirit of the Pact. Its recommendation, in spring, to send an early warning to Germany and Portugal has been verified by developments since. Yet its failure to convince the Council and its recent retreat concerning the deadline for budget consolidation clearly demonstrate that at least the larger member countries are not prepared to yield more authority to the Commission. As to the Council, the very disregard of the commitments of the Stability Pact, the collusive behaviour of France and Germany in fending off the early warning, and the outright refusal of France to reduce its structural deficit, as recommended by the Council, witness that the Council is unable to deliver what it promises. Economic governance of the EU at the discretion of the Council and its more powerful members is no improvement over the binding rules of the Stability Pact. Quite on the contrary, it is an invitation to lax and irresponsible fiscal behaviour.

At present, the Stability Pact may not really be needed to fend off inflation nor to support the euro in the foreign exchange market. Adherence to the Pact remains essential, however, to maintain and strengthen the credibility of the EU to its citizens. In a period when the Union enters into the adventure of admitting ten new members at one blow that credibility is needed more than ever. Member countries must therefore demonstrate that violations of the criteria remain one-off events and that such violations give rise to a positive policy shift rather than attempts to soften the rules of the game. And the Commission must stay firm in its demand that the limit for the nominal deficits be obeyed and the structural deficits be reduced along a predetermined path. It should monitor that process and watch over the quality of the consolidation. Yet it should be flexible as far as the timing for the decrease of the nominal deficits is concerned. This timing must take account of the cyclical situation – as the Stability Pact indeed foresees. Finally the Commission should continue to issue early warnings whenever appropriate, and stay firm on them.

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