The Stability and Growth Pact: Stability without growth?

Catherine Mathieu, Henri Sterdyniak

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1. Introduction

With the launch of economic and monetary union (EMU), a new frame-work for the conduct of economic policies in Europe has been implemented. The ECB's independence, the Stability and Growth Pact (SGP) and the focus on structural reforms show that 'liberal' views have won over 'Keynesian' ones. The weaknesses of this framework soon emerged, however. The euro area remains a low growth area. Rigid rules lacking economic rationale have induced persistent tensions in Europe.

2. An inappropriate framework

From a Keynesian perspective, independent national fiscal policies are necessary in EMU because monetary and exchange rate policies are run at the euro area level and become ineffective in the event of asymmetric shocks. Moreover, fiscal policy gains strength in a monetary union since it will not be counteracted by interest rate rises or an appreciating ex-change rate.

Taking the monetarist view, EMU needs binding rules to constrain fiscal policies. Otherwise, governments will run over-expansionary policies exactly because they do not need to be concerned about interest rates, external balance or speculation on the exchange rate. This view, supported by central bankers and the German government, has prevailed and the SGP focuses on public finance objectives rather than on economic growth. Hence, the SGP is not a coordination process, but rather a forced convergence towards *a priori* norms.

The SGP can also be seen as a way to impose a new conduct of fiscal policy, in line with what we call the federal, technocratic and liberal ide-ology (FTLI). This ideology aims at depriving governments of all leeway. It gives them incentives to cut public expenditure and implement liberal structural reforms, while preventing expansionary macroeconomic policies. Governments have signed this Pact because they and their national technocrats share this dominant ideology. Instead of active economic policies, European dominant classes favour structural reforms that increase labour market flexibility, cut taxes and public expenditure, and increase company profits.

The monitoring of euro area fiscal discipline is based on three elements: two criteria are inherited from the Maastricht Treaty (the 3% of GDP deficit threshold and the 60% reference value for the ratio of debt to GDP). The third element is the institutional frame-work for the implemen-tation of fiscal surveillance (the SGP).

The 3% deficit ceiling is the absolute reference. However, it has no economic rationale. Why 3%? The reasons given are awkward. A deficit of 3% of GDP would stabilise the debt level at 60% of GDP under nominal GDP growth of 5%. But, apart from the fact that the reference should then apply to the cyclically-adjusted balance or to average borrowing over an economic cycle, why the 60% figure for the debt-to-GDP ratio?

Moreover, a country hit by a specific fall in domestic demand may very well need a deficit higher than 3% of GDP. *A priori*, such a deficit will not raise inflation. It also benefits partner countries by avoiding the negative impact that would otherwise result from falling domestic de-mand. In 2003, the public deficit reached 4.1% of GDP in Germany, but inflation was low (1.0%) and the current account showed a surplus (2.1% of GDP). It is difficult to claim that the German public deficit generated negative spillover effects. Moreover, the budgetary procedures of the SGP do not prevent the emergence of excessive inflation. For example, inflation reached 5.1% in the Netherlands in 2001 while government borrowing was balanced.

In the past, deficits have been higher than 3% of GDP quite often in many OECD countries. At that time, they were seen as necessary to support output. In theory, the discipline the SGP is imposing would not be so much of a problem if monetary policy were

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more growth-oriented, but this is not the ECB's remit. Moreover, a single monetary policy cannot fit different national cyclical positions. GDP growth and inflation differ significantly among euro area economies (see Table 1). With an inflation target set at 2% by the ECB, the interest rate given by a Taylor rule ranged from 1.5 in the Netherlands to 7.3 in Ireland at the end of 2005. So the 2% interest rate set by the ECB was too high for the Netherlands and Germany whereas it was, although at varying degrees, too low for the rest of the monetary union.

With a single interest rate, a single public deficit-to-GDP ratio existing independently of the level of domestic demand cannot be optimal for each country.

Table 1: Interest rate, GDP growth and inflation forecasts, October 2005

	GDP growth%	Consumer prices, %	Differential (1)	Output gap	Interest rate target (2)
Germany	0.9	1.9	-0.8	-2.7	1.9
France	1.6	1.8	-1.4	-2.1	2.9
Italy	0.3	2.1	-0.4	-2.0	2.5
Spain	3.3	3.3	-4.5	-0.8	6.4
Netherlands	0.9	1.5	-0.4	-4.0	1.5
Belgium	1.6	2.5	-2.1	-1.5	4.0
Austria	2.0	2.2	-2.2	-2.2	3.6
Finland	2.1	1.3	-1.3	0.1	3.2
Portugal	0.9	2.3	-1.2	-4.4	2.7
Greece	3.3	3.3	-4.6	0.5	7.1
Ireland	4.9	2.4	-5.3	-0.6	7.3
Euro area	1.4	2.1	-1.5	-2.3	3.0

(1) Differential between the short-term interest rate (2%) and consumer price inflation plus real GDP growth forecasts 1 year ahead (as of October 2005).

(2) Defined as [π= g + P + 0,5 (P-2) + 0,5 (output gap)] where g: potential output growth, P, inflation rate and :(x-y) OECD's output gap.

Sources: Consensus Economics, OECD (2005), authors' calculations.

The Treaty states the obligation for countries to keep their public debts below 60% of GDP or otherwise to bring debt below this ceiling. But as countries with public debts well above 60% of GDP were allowed to join the euro area (Italy, Belgium and Greece), this constraint has been 'forgotten' since 1997.

Thirdly, the SGP requires euro area countries to submit annual stability programmes. The latter must have macroeconomic and budgetary projections for the current and three following years, targeting a budgetary position 'close to balance or in surplus' in the medium-run. However, such a target has no economic justification. A country in which private savings are spontaneously too low (high) may need some budget surplus (deficit). Moreover, it is reasonable to finance public investment through borrowing and therefore some public deficit may be justified. And keeping deficits permanently at 0% of GDP will result in a nominal public debt in continuing decline as a percentage of GDP. Here, it needs to be pointed out that there is a demand for public debt from financial markets, especially from pension funds that need to invest in long-term, liquid and safe assets. Finally, eliminating public deficits and debts may result in very low interest rates, which would limit the room to act if the country were to be hit by a negative demand shock.

At the Ecofin Council of July 2001, Member States accepted the Commission proposal to set a target of balanced (as measured by the Commission) structural budgetary positions. Once this target is reached, only automatic stabilisers will be allowed to work, while discretionary policy will be excluded. Thus, fiscal policies will become automatic and Member States will lose all fiscal autonomy. The justification for the proposal was that discretionary fiscal policy is dangerous because governments can misjudge the economic situation or permanently run expansionary policies. Furthermore, the Commission, pointing to the disincentives on work caused by taxes, was insisting that public deficits be reduced through spending cuts and not through increased taxation.

Ultimately, the SGP does not offer a framework for coordination of macroeconomic policies. The SGP does not set a strategy and a target for economic growth in Europe. Monetary authorities do not take part in the process. The cyclical position of the European economy, whether global or country-specific, is not really taken into consideration. National programmes are evaluated separately, without analysing their impact on partner countries. A satisfactory coordination process would do the opposite. It would examine precisely the economic situation of the area as a whole in order to set the appropriate level of interest rate, and then switch to the analysis of domestic situations in order to decide which fiscal policies need to be implemented at the national level.

3. From 1997 to 2005: the SGP undergoes reform

3.1. Eight years, twelve sinners

From 1997 to 2000 robust growth and declining interest rates, together with a small positive fiscal impulse (0.3% of GDP per year according to the OECD, see Table 2), allowed public deficits to fall in the euro area. Public deficits started to rise again in 2001-2002 because of decelerating economic activity and because the fiscal impulse still remained slightly positive. Despite the repeated requests of the Commission, the euro area's primary structural surplus decreased over the 1997-2002 period.

Table 2: General government balances in the euro area
Percentage of GDP

	Government balance	Cyclical component	Interest payments	Cyclically-adjusted primary balance
1997	-2.6	-0.7	4.5	2.5
1998	-2.3	-0.3	4.2	2.2
1999	-1.3	-0.0	3.6	2.3
2000	-1.0	0.7	3.6	1.7
2001	-1.9	0.6	3.5	0.8
2002	-2.5	0.0	3.3	0.5
2003	-3.0	-0.6	3.1	0.4
2004	-2.7	-0.7	2.9	0.5
2005	-2.9	-1.0	2.8	0.5

(1) Excluding proceeds from the sale of UMTS licences.
Source: OECD (2005).

Since the economic slowdown of 2001, the SGP has generated permanent tensions in Europe. The Commission has been asking for cuts in public deficits even as Member States try to support growth in a situation of high unemployment and weak inflation. The crisis erupted in November 2003 when the Council refused to adopt the Commission recommendations calling on France and Germany to strongly reduce their structural deficits in 2004 and 2005. The Council then adopted a less stringent conclusion which was accepted by the French and German governments. The Commission however was of the opinion that the Council did not have the right to refuse its recommendation; procedures and fines should be automatic. So the Commission put the case before the European Court of Justice. According to its verdict, Member States retain the right of appreciation in the excessive deficit procedure (EDP), but recommendations on excessive deficits can be modified by the Council only on the initiative of the Commission. So the Commission and a qualified majority of the Council must reach agreement.

In September 2004, it came to light that the public deficit figures provided by Greece had been false since 1997 and that the Greek deficit had never fallen below 3% of GDP. In 2005, deficit figures for Italy and Portugal were also raised. In December 2005, 12 EU countries were su-jected to an Excessive Deficit Procedure: five in the euro area, the UK and six new Member States. In most new Member States, public deficits are higher than 3% of GDP, but public debt remains below 60% of GDP, while these countries also have significant public infrastructure needs. From 1998 to 2005, the 3% ceiling has been breached for eight years by Greece, five years by Italy, four years by France and Germany, two years by Portugal and one year by the Netherlands.

3.2. On national views

Some countries, like Spain, oppose any change in the Pact. Spain benefits from robust growth thanks to low nominal interest rates as compared to domestic inflation and GDP growth, and does not need any expansionary fiscal policy. However, with inflation at 3.6% and a current account deficit at 7.4% of GDP for 2005, Spain is less virtuous than Germany, where inflation is 2.0% and the current surplus 3.8% of GDP. Some small countries like the Netherlands, Belgium and Austria use the European disciplinary framework to cut their public debts and are also opposed to a reform of the Pact.

The larger countries have called for a reform of the Pact. In November 2004, Silvio Berlusconi called for a Pact oriented towards growth rather than stability. He suggested the exclusion of public capital and R&D expenditures from the deficit figures. Gerhard Schröder claimed that the judgement on excessive deficits should take account of several criteria, e.g.: the introduction of reforms that are costly in the short run but boost growth in the long term; the country's contribution to price stability in Europe; the economic situation; the net contribution to the EU budget and, as concerns Germany, transfers to new Länder. The French government suggested the exclusion of military spending and aid for developing countries.

Ultimately, European cohesion was at stake in this discussion. On the one hand, the three largest countries represent 75% of the euro area population and might have vetoed a reform. On the other, several smaller countries accused Germany and France of not complying with European rules. But some of these smaller countries receive Community funds, benefited from falling interest rates when joining the EU and are less in need of independent fiscal policies than bigger states because they can more easily implement tax competition or competitiveness policies, both of which are harmful strategies at Community level.

3.3. The new Pact

At the March 2005 Council, Member States agreed on a text prepared by the Commission. The Council stated that the economic rationale of budgetary rules had to be enhanced but also that the 3% of GDP value for the deficit ratio had to remain the centrepiece of multilateral surveillance.

Part II, **'Strengthening the preventive arm'**, agrees to the definition of medium-term objectives (MTO) that are differentiated for each Mem-ber State. *But the range goes only from -1% of GDP for low debt/high potential growth countries to balance or surplus for high debt/low potential growth countries. Why wasn't the golden rule for public finance considered, or a deficit stabilising public debt at a reasonable level (i.e. a structural deficit objective of around 2% for a country with nominal growth of 4% and a target of 50% for the debt ratio; and around 3% for a country with nominal growth of 7.5 % and a target of 40% for the debt ratio)?*

The implicit liabilities from ageing populations will be taken into account. *However then why not take the social contributions that people will pay to have a satisfying level of pension and health insurance into account as well? Countries with generous public pensions systems may decide to have a higher tax burden than countries where employees need to save on an individual basis in view of retirement or health spending*.

Member States not having reached their MTO should make a budget-ary effort of 0.5% of GDP per year (cyclically adjusted and excluding one-off measures). The effort should be higher in periods when the out-put gap is positive, smaller in bad times. *However potential output and the economic cycle are difficult to assess. For example, the Commission's estimates point to small output gaps. If this is the case, and despite a high unemployment rate, even a short period of growth would then lead to an overheating economy.*

Structural reforms, in particular pension reforms introducing a manda-tory, fully funded pillar, will be taken into account if they raise potential growth and induce long-term savings in the long run. *However shouldn't the design of the social security system be a national choice? There is no justification for a European rule providing incentives for a fully funded system.*

Part III is entitled **'Improving the implementation of the excessive deficit procedure'**. The Commission will prepare a report if the deficit exceeds 3%. A small and temporary breach of the rule will be allowed if it is due to negative growth or a strong negative output gap. The proposal tabled by France, Germany and Italy to withdraw certain categories of expenditure from the deficit has not been accepted. However, will be taken account of 'all relevant factors' such as policies implemented in the framework of the Lisbon agenda, R&D spending, public investments, economic situation or debt sustainability. These elements may prevent triggering of the excessive deficit procedure (EDP) but only if the excess is limited and temporary. They could also allow for longer adjustment paths to bring deficits below 3%. Then again, for countries with debts in excess of 60% of GDP, the Council will take account of the speed of reduction in the debt-to-GDP ratio.

The Commission maintains the right to prepare a report for each country surpassing the ceiling and will be entitled to send an early warning directly. But the state concerned will be entitled to justify its policy by referring to a number of relevant factors. In other words, implementation of the EDP will not be automatic. It will require judgements on the policy choices of the state concerned. One intriguing question is here how peer countries can condemn a policy conducted by an elected government, if this policy generates no negative externalities?

This agreement may be viewed as a serious weakening of the Pact. On the other hand, there is no reflection on the objectives of fiscal policy or on measurement of the output gap; the easing of the medium term objective is very limited; the requested annual 0.5% decrease in structural deficits to GDP ratios remains. Governments will continue to have to justify domestic fiscal developments before the Commission and other member states. The Pact will remain a factor of permanent tensions in Europe.

The ECB, in particular Otmar Issing, has expressed strong concerns about the reform, saying that 'the conflicts between lax public finances and a monetary policy centred on price stability would endanger the construction of monetary union'. But it is difficult to see how a country with a public deficit, low inflation and an external surplus, with all of these being the consequence of weak domestic demand, can threaten euro area price stability.

4. How to improve the fiscal framework?

The need for reform of the SGP has generated significant literature.

4.1 Fiscal Policy Committees

Wyplosz (2002) has proposed the creation of a fiscal policy committee of independent experts in each Member State. These committees would have the mandate of ensuring debt sustainability and would set the level of government borrowing, while public spending and receipts would remain under the control of national governments and parliaments. Fatás et al. (2003) have made a more moderate proposal: a European Sustainability Council, an independent panel of experts, would assess national fiscal policies according to sustainability criteria. Their judgment would be made public, to enforce fiscal discipline through public opinion and financial markets. But debt sustainability is a vague concept that makes sense as a long-term constraint only and would be difficult to consider for the conduct of fiscal policy in the short term.

In economic downturns, what trade-off would the Committee make between output and debt stabilisation? Could these experts' judgments replace governments' responsibilities? For instance, in 2004, some European countries chose to run high deficits rather than depress output further. Could these experts claim that such policies were not sustainable? Following on from the ECB's independence, this would be a further step towards leaving economic policy under the responsibility of a technoc-racy.

4.2 Public debt surveillance

Pisani-Ferry (2002), Gros (2003) or Calmfors et al. (2003) have pointed out that fiscal discipline should focus on debt rather than deficits, since it is excessively high debt that may threaten the sustainability of public finances. Without considering the cyclical effects on debt-to-GDP ratios deteriorating automatically in times of subdued activity, they suggest that the limit for deficits should depend on public debt levels. This would be an incentive for member states to cut public debt in order to get more cyclical leeway. The proposal puts constraints on highly indebted countries: Italy, Belgium and Greece. But the constraint is questionable for Italy and Belgium where public debt has a counterpart in a high households' savings ratio. The constraint comes in addition to the objective of a medium-term balanced budget, which already implies a continuing decrease in the public debt-to-GDP ratio.

Old-age-related public spending – pensions and health – will increase under the effects of ageing populations in the EU in the near future. Some economists (among them Pisani-Ferry 2002 and Oksanen 2004) suggest that each country should evaluate and make public the implicit debt level of its public pension and health systems, in addition to financial debt. What should the implicit debt include? Why not include also public education spending entitled to newborn children? In any case, anticipated receipts should be considered too, like taxes and social contributions. The proposal paves the way to a never-ending process of complicated calculations surrounded with a high degree of uncertainty. Indeed, the estimated level of implicit debt relies on many assumptions concerning future retirement age and pensions levels. The implicit debt level may be greatly reduced, effectively or fictively, if the country announces in advance that the level of pensions will be lowered or that the retirement age will be postponed (as France did in 2003). Ultimately, the real question is not to aggregate financial public debt and implicit social debt but to determine whether fiscal policy is sustainable and optimal. If house-holds benefit from a high, well managed and useful level of social spending, they may accept a high level of contributions. The burden could even be less heavy than having to pay insurance premiums to inefficient or unreliable private companies.

Many economists (among them Delbecque 2003, Oksanen 2004) and the Commission think that the SGP rules are justified by the future rise in pension spending. Their view is that public debt needs to be significantly reduced now to ensure the future pensions. This is necessary for inter-generational equity reasons (all generations sharing the tax burden) as well as economic efficiency (avoiding imposing too heavy a tax burden on future generations). However, the fundamental rationale and objective of the Pact is to facilitate fiscal policy coordination and to avoid negative externalities inside monetary union, and not to give technocrats the power to set what they think are optimal fiscal policies for each country.

4.3 The golden rule for public finances

Public investment has positive return effects over a longer time period and it is therefore logical for it to be financed over a similar period of time. Independently of short-term stabilisation concerns, government budgets should be split into a current budget - including spending related to public capital stock depreciation - which should be balanced, and an investment budget, financed through borrowing. The British government adopted such a rule, the so-called 'golden rule for public finances', in 1998. Several economists (Modigliani et al. 1998, Creel et al. 2002, among others) have suggested importing this rule into the euro area. The structural current government balance, i.e. excluding public investment, should be permanently balanced or in surplus. If the objective is to keep public debt at the level of public capital stock, which may be judged de-sirable from an intergenerational equity point of view, the golden rule must be that the cyclically-adjusted borrowing should be in balance with net public investment (Mathieu/Sterdyniak 2004).

The golden rule allows governments to borrow to invest, which is of paramount importance for countries with significant investment needs like the new Member States. According to endogenous growth theory, cuts in public investment negatively affect potential output growth. However, the golden rule approach opens a Pandora's box on the definition of public investment: should the national accounts definition be the reference, or should all expenditure preparing the economy for the future, like education or research, be also taken into account, as proposed by Fitoussi (2002)?

The golden rule defines fiscal policy neutrality, cyclical neutrality (only automatic stabilisers are allowed to work) and structural neutrality (public savings equal public investment). However, a government may decide not to be neutral. It may wish to implement an expansionary fiscal policy in times of slow growth or to run a contractionary policy in a period of high inflation. It may wish to implement structural measures if it thinks that savings are too high ex ante (which would necessitate an excessively low interest rate) or too low (in the light of demographic changes). As with the existing rule, there is no certainty that application of the golden rule results in a fiscal policy stance which, given the level of interest rates at the level of monetary union, delivers a satisfying level of output in the member state.

4.4. Reforming European economic governance and improving policy mix

The European fiscal and monetary framework is a highly political issue. What powers should be in national or community hands? It is also a technical issue: a single monetary policy and different fiscal policies need to be consistent with one another.

An elected economic government of Europe, making fiscal decisions for all, is currently a utopia. The democratic debate has remained at the national level while at the same time business cycles as well as institu-tions still differ from one country to another.

Given the current level of European political integration, governments must keep their prerogative on national fiscal policy. The European surveillance of member states' economic policies should be limited to preventing any national fiscal policy from negatively affecting the rest of the area. That is why binding rules should bear directly on externalities. Thus, the rule should be that countries are allowed to implement the fiscal policy of their choice, as long as it does not affect the macroeconomic equilibrium of the area, in other words as long as domestic inflation stays in line with the inflation target of the area. For example, one could think of an inflation target being set between 1.5% and 3.5% in the area. 'Northern' countries could then choose a target within 1 and 3%, while lagging countries would target an inflation rate between 3 and 5%. In such a framework, a country hit by a negative demand shock would be able to counterbalance it through an expansionary fiscal policy. Conversely, a country hit by inflationary pressures would have to implement restrictive measures.

The European authorities – the Commission and the Ecofin Council of the euro area – would be responsible for checking that inflation remains at the level set in each country, and possibly accepting some deviations and adjustment periods in the event of specific or common shocks. The European authorities could also be responsible for checking that domestic public debts do not put the sustainability of public finances at risk, or that no country runs an excessively large current account deficit relative to the area current account balance.

However, this framework does not set the respective roles of monetary policy and fiscal policies. A satisfying level of global demand may be obtained through a combination of high interest rates and public deficits, or of low interest rates and public deficits. The second combination will lead to higher private investment and therefore will be preferable in terms of medium-term output growth. In other words, the compatibility between monetary policy and fiscal policies has to be organised. In our view, the best rule is the following: monetary and fiscal policies should set a common objective aiming at

the convergence of real interest rates and output growth. For example, if long-term real interest rates are higher than output growth, this implies that investment is too weak. In that case, monetary policy should cut interest rates and should be accompanied by restrictive fiscal policies in those countries where the interest rate cut would raise inflation excessively. National fiscal policies should be responsible for managing the inflation-production trade-off in each country while monetary policy should target the interest rate.
In addition, it would be desirable to set up economic policy coordina-tion in the framework of the Eurogroup, which would maintain a dialogue with the ECB. This coordination should not focus only on public finance balances, but should aim at supporting economic activity and achieving the 3% growth target of the Lisbon strategy. It should be kept in mind that improving the European fiscal framework is not merely a technical issue, but requires a new alliance between social classes con-cerned about full employment and social cohesion.

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