Comments on reforming the Stability and Growth Pact *

Importance of sound public finances

Sound public finances are a key component in ensuring a stable medium and long-term path of economic development. They boost potential growth by strengthening public confidence, thus making it easier for both consumers and investors to make long-term decisions. Furthermore, low deficit and debt ratios tend to result in a low interest rate level, which means that investment can be financed on favourable terms.

By contrast, government budgetary imbalances may hamper growth prospects even if they are only looming in the future. If market participants fear that sustainability problems will arise over the long term, this may prompt them to change their behaviour in the present. Unresolved fiscal problems originating, for example, from future budgetary burdens due to demographic developments may lead to expectations of rising taxes and social security contributions in the future and thus deter long-term investment. Budgets that are balanced or in surplus will, by contrast, allow the debt ratio to be reduced and will therefore lower the interest burden on general government. This makes it easier to deal with demographically induced burdens.

Unsound public finances may also lead to conflicts between budgetary policy and monetary policy by putting pressure on the central bank to reduce the real value of government

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debt by easing its monetary policy stance. High rates of inflation were often caused in the past by an evolution of public debt that was unsustainable in the long term. Actual or expected conflicts between monetary policy and fiscal policy may result in a loss of public confidence which impairs economic development. Sound public finances are therefore a crucial requirement for enabling the central bank to ensure permanent price stability at low interest rates.

A sound budgetary position also increases the fiscal policy contribution to stabilising cyclical fluctuations. If public finances are already unbalanced at the beginning of a downturn, there may not be sufficient scope to tolerate a further cyclically induced increase in the deficits. Moreover, the effectiveness of fiscal policy may weaken in such a situation if market participants assume that the growing budgetary imbalances will have to be corrected in the medium term. This increases uncertainty concerning the tax and social security burden and transfer payments.

Rules for sound public finances are particularly important in a monetary union because the disciplining effect of the financial markets and the associated incentive to pursue a sound fiscal policy are less pronounced. Creditors can no longer demand an interest rate premium as compensation for the national inflation and depreciation risk. A member state with an excessive level of borrowing basically suffers only the effects that, as a result of its fiscal policy, arise for the currency area as a whole and which therefore also affect countries with a sound fiscal policy. In the case of a single monetary policy, it is therefore all the more necessary to avoid excessive deficits by means of a stringent budgetary surveillance process.

The 1997 Stability and Growth Pact, which detailed the provisions of the Maastricht Treaty, was designed to ensure that all participating countries exercise budgetary discipline, including after their accession to monetary union. The requirement of achieving a budgetary position which is balanced or in surplus in the medium term also created a safety cushion vis-à-vis the 3% reference value for the deficit ratio, which allows the automatic stabilisers to take effect over the course of the business cycle. The reference value stipulated by the Maastricht Treaty represents the upper limit for the government financial deficit.

Experience of budgetary rules

The requirement that countries have to meet the convergence criteria before they can join monetary union contributed to the public finance consolidation progress in the EU member states up to 1997. In the stability declaration of 1 May 1998, the governments pledged to further reduce the deficit in economically favourable phases and lower their debt levels faster. Finally, in October 1998, they agreed to achieve the medium-term budgetary objective by 2002.

However, soon after the start of monetary union the consolidation efforts eased up. Some EU countries did not make use of the

economically favourable years initially to fundamentally consolidate their public finances. Germany, too, failed to achieve the required structurally balanced budget. Consequently, its budget deficits rapidly rose above the 3% ceiling during the ensuing economic slowdown. This was not due solely to cyclical effects. Rather, the budgetary position also deteriorated considerably when adjusted for cyclical influences. This was mainly attributable to the significant decline in the government revenue ratio, which in turn was partly caused by tax cuts which, while desirable *per se,* were insufficiently counterfinanced.

In January 2002 the European Commission recommended the Council to issue early warnings to Germany and Portugal because the budgetary development in both countries was distinctly worse than expected. Their deficits were coming dangerously close to the 3% reference value. However, the Council did not follow these recommendations since Germany and Portugal promised to take all the measures necessary to avoid breaching the 3% ceiling. In November 2002, the Council finally decided that Portugal had an excessive deficit. The deficit figures for the previous years had meanwhile been revised upwards drastically, with the result that the reference value had been exceeded already in 2001.

In January and June 2003 Germany and France were likewise adjudged to have run up an excessive deficit in 2002. Both countries were ordered to correct their deficit situation by the end of 2004. When it became clear at the end of 2003 that neither Germany nor France would meet the correction deadline, the Commission recommended the Council to give notice to both countries in line with the provisions of both the Maastricht Treaty and the Stability and Growth Pact. The recommendation also envisaged extending the deadline for correcting the deficits until the end of 2005. These recommendations to implement the tightening of the excessive deficit procedure did not find the required majority of votes within the Council meeting on 25 November 2003. Instead, the Council adopted conclusions suspending the initiated excessive deficit procedures. Germany and France pledged to correct their deficits in 2005 at the latest.

The Commission’s appeal against these Council decisions to the European Court of Justice was successful to the extent that on 13 July 2004 the Court declared the conclusions to be void since they came about outside of the prescribed statutory procedure. It was around six months before the Commission provided the Council with a statement on the excessive deficit procedures against Germany and France in which it declared that it recommended taking no further measures against either country as it was likely that the deficits would be corrected in 2005.

The reform proposals

Six years after the start of the third stage of economic and monetary union, the public finance situation in several EU member states is highly problematic. The fiscal framework has also lost credibility. It is endangered. An

excessive deficit procedure was initiated in six of the new EU member states in 2004. In the European Commission's autumn forecast, three of the "old" EU countries were exhibiting deficits of more than 3% of GDP for 2004. What is particularly problematic, however, is that in September 2004 the Commission reacted to the problems associated with the Pact's implementation by proposing changes which largely meet the demands of the deficit countries to relax the regulations.

In particular, the Commission is in favour of taking greater account of country-specific circumstances. It substantiates this with the higher degree of heterogeneity among member states of the European Union following the most recent round of enlargement. It argues that an improved "economic ratio" resulting from taking greater account of country-specific circumstances will raise members states' willingness to obey a changed set of rules. The main proposed criteria for such a differentiation are the level and development of a country's debt ratio, the economic situation, the implementation of structural reforms and the need for additional public investment. Essentially, the Commission proposed the following changes.[1]

1 The possibility for the Commission to issue early warnings directly to the member state concerned in the event of inadequate budgetary developments, ie without seeking the approval of the Council. This – together with suitable recommendations under the Broad Economic Policy Guidelines – is intended to ensure sound fiscal policy in times of economic upswing, too.

2 Greater emphasis on the debt level and the sustainability of public finances. This could include clarifying the provision laid down in the EC Treaty whereby debt-to-GDP ratios above the 60% reference value are deemed to be "sufficiently diminishing" and approaching the reference value "at a satisfactory pace".

3 Greater consideration of country-specific circumstances (particularly those concerning the size and development of the debt-to-GDP ratio) when defining the medium-term budgetary objective of "close to balance or in surplus". The medium-term objective is to be specified in the context of countries' specific circumstances, while the current definition is to be abandoned.

4 Consideration of country-specific circumstances and developments in the implementation of the excessive deficit procedure. The Commission suggests both widening the definition of the exceptional circumstances in which countries may breach the 3% ceiling and extending the deadlines for correcting excessive deficits.

At its meeting on 11 September 2004, the Ecofin Council considered the Commission's proposals to be a sound basis for discussion. Since then, further proposals have been intro-

1 See European Commission, *Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact*, Communication from the Commission to the Council and the European Parliament of 3 September 2004.

duced into the debate about a reform of the EU's fiscal framework. In particular, it has been suggested that certain expenditure categories should not be counted towards the 3% ceiling or considered when interpreting the deficit. The categories mentioned include government expenditure which could raise the growth potential in the member state concerned (for example, spending on investment, education or research and development) as well as military expenditure and net payments to the European Union.

Particularly problematic are the suggestions for changing the medium-term budgetary objective. This would then deviate from the current interpretation, according to which the cyclically adjusted deficit ratio should be ½ percentage point at most. This will result in the rules becoming increasingly more complicated and opaque. Their enforceability would be reduced. Moreover, relaxing the criterion for some countries would increase the risk of the deficit ratio exceeding the 3% ceiling in times of economic downturn.

Furthermore, any relaxation of the reference value for the deficit ratio by widening the exception clauses or extending the correction deadlines must also be rejected. Such changes would weaken the disciplinary effect via the threat of sanctions and lead to greater discretionary leeway. The binding commitment to fiscal rules would, in effect, be abandoned. Thus, there is a risk that, in future, deficits of more than 3% of GDP could prove to be the rule rather than the exception in some countries. The associated debt accumulation would not only contradict the fundamental objectives of the fiscal framework, it would also make it more difficult to overcome future burdens expected from demographic changes.

The proposal that certain expenditure categories should not be counted towards the 3% ceiling or considered when interpreting the deficit must likewise be rejected. This would effectively signify the abolition of the 3% ceiling. This could lead to sustainability problems which would impair the underlying conditions for sustainable growth and a stability-oriented monetary policy. Besides these fundamental objections to carving out specific expenditure categories, it should be pointed out that such a reform would entail virtually insurmountable statistical problems.

Finally, the demand that net payments to the European Union should likewise not be counted towards the deficit is economically unconvincing. Instead of shifting the financing burdens onto future generations by borrowing, payments to the EU should be met out of current revenue. Proposals to relax the 3% ceiling suggest that it would be advantageous for a member state if its government had the greatest possible borrowing capacity.

Conclusion

The Stability and Growth Pact manifests the European governments' pledge to contribute to the stability of the single currency by means of sustainable public finances. This pledge was addressed not least to the

German population which, in relinquishing the Deutsche Mark, had to surrender a currency which symbolised the economic miracle of reconstruction following the Second World War and was a hallmark of solidity. The Pact was an important consideration in the Deutsche Bundesbank's positive statement on the introduction of the euro. It is one of the cornerstones of monetary union.

It is regrettable that, following the introduction of the euro, the willingness to adhere to fiscal policy rules has waned. The Pact does not represent an economic "straitjacket", the provisions of which can only be met at the cost of economic stagnation and a powerless economic policy. In practice, this is corroborated by the examples of other EU economies in which economic growth and sound public finances go hand in hand. The Pact is sufficiently flexible; it is primarily an instrument of prevention.

The Stability and Growth Pact has an implementation problem, which will not be resolved by any proposed reforms. This goes back to the fact that in the negotiations leading up to the Pact the German demands for relevant decisions to be triggered automatically were rejected in favour of giving the Council discretionary leeway at the various stages of the budgetary surveillance procedure. Another problem is that actual and potential deficit countries are not excluded from participating in all stages of the decision-making process.

The Bundesbank believes that the proposed changes would not strengthen the Stability and Growth Pact but, instead, would decisively weaken it. The relaxing of fiscal rules might instigate a paradigm shift in budgetary policy in the EU member states and lead to developments in economic and monetary union that would make conflicts between fiscal and monetary policy more probable. The incentive to pursue sound budgetary policies in the countries participating in monetary union would be lessened. Furthermore, wrong signals would be sent to those countries which have not yet introduced the single currency.

The Treaty and the Pact currently comprise a fiscal framework whose transparent rules follow cogent objectives. By contrast, the reform proposals represent a set of exceptions, the parts of which do not form a coherent whole. The principles of simplicity, transparency, equal treatment, consistency and operational viability – which characterise the quality and enforceability of any set of rules – will be sacrificed in favour of greater flexibility. If growing discretionary leeway and more complicated provisions make exceptions the rule, the credibility of the Community's commitment to stability will be lost. In the long run this will harm all member states. If during the implementation of the reform the budgetary provisions are revisited and reformulated, there is a danger that additional demands for reform will be presented that go beyond the existing ones.

The negative experience of undesirable fiscal policy developments in the past decades

should be carefully heeded, also with a view to the Community's changing demographic situation. A reform or reinterpretation of the well-founded Stability and Growth Pact entailing a relaxation of the commitment to fiscal policy soundness must be rejected. Short-term budgetary relief should not be purchased at the expense of future generations.