How to Reform the Stability and Growth Pact

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Abstract

Fiscal rules in a monetary union should (1) be simple; (2) ensure the solvency of the state; (3) avoid pro-cyclical behaviour of the fiscal policy instruments; (4) make sense also in the long run; (5) allow for important differences in economic structure and initial conditions; (6) aggregate into behaviour that makes sense at the level of the union as a whole; (7) be credible and (8) be enforced impartially and consistently. This paper reviews the extent to which the fiscal rules of the Stability and Growth Pact meet these criteria and makes some suggestions for reform.

Key words: Fiscal rules, Stability and Growth Pact; Golden Rule; Financial Sustainability.

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Introduction.

When a father calls his baby ugly, people take notice and expect to find a seriously aesthetically challenged child. When the President of the European Commission calls the fiscal rules of the Stability and Growth Pact 'stupid' and 'rigid', it is clear that changes to the Pact are in the air.[1]

In this article I consider the strengths and weaknesses of the fiscal rules imposed by the Stability and Growth Pact and compares it with two alternatives, the UK fiscal rules (the *golden rule* and the *sustainable investment rule*) (see Balls and O'Donnell [2002]) and the *permanent balance rules* proposed by Buiter and Grafe [2003].

The ultimate objectives the rules aim to achieve are common ground. They are: (1) the financial sustainability of the state, (2) the efficient financing of public spending and (3) and macroeconomic stability, that is, the elimination of unnecessary and undesirable fluctuations in economic activity. It is a formidable task indeed to design a rule, or set of rules, that makes sense for a group of 15 and soon 25 countries, ranging from the mature industrial economies of Western Europe to the least advanced among the eight Central and East European transition countries that are scheduled to become EU members as early as May 2004.

The Stability and Growth Pact fiscal rules are given as follows:

[1] In an interview with Le Monde on 18 October 2002, EU Commission President Romano Prodi said that the rules which govern the Euro – the Stability and Growth Pact - are "stupid". His exact words were: "I know very well that the Stability Pact is stupid, like all decisions that are rigid." That same week, EU Trade Commissioner Pascal Lamy described the Pact as "medieval" and praised the economic framework that the United Kingdom has established.

(1) the general government financial deficit can be no higher than three percent of GDP, except under exceptional circumstances (under conditions of 'severe recession'). The UK, because of its EMU opt-out, is not subject to this requirement.

(2) Over the medium term, the general government financial deficit should be "close to balance or in surplus". The UK is subject to this requirement.

For EU members not yet full members of EMU but striving to qualify, there is in addition the requirement that gross general government debt should not exceed 60 percent of annual GDP. In the past, not meeting this requirement has not been an obstacle on any country becoming a full EMU member.

The UK's budgetary rules are as follows:[2]

The *golden rule*: over the economic cycle, the government will borrow only to invest and not to fund current spending. It is met when, over the economic cycle, the current budget is in balance or surplus; and

The *sustainable investment rule*: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things equal, a reduction in public sector net debt to below 40 per cent of GDP over the economic cycle is desirable.

The *permanent balance rule* is a 'tax-smoothing rule': tax revenues are planned to be a constant share of GDP, the permanent tax rate or share. This share is the lowest constant share of tax revenues in GDP that would, in the absence of news and surprises, ensure the long-run solvency of the government. It is given by sum of (1) the permanent share of non-interest public spending in GDP (roughly the long-run average share of non-interest public spending in GDP, looking forward) and (2) the permanent government interest bill, as a share of GDP, calculated as the product of

the debt-to-GDP ratio and the excess of the long-run real interest rate over the long-run growth rate of real GDP.

The permanent balance rule implies that the permissible general government budget deficit as a fraction of GDP is the sum of three components. The first is the reduction in the debt-to-GDP ratio due to nominal GDP growth (inflation and real GDP growth). For example, if annual real GDP growth and annual inflation are both 2.5 percent and the debt-to-annual GDP ratio is 40 percent, this component would permit a deficit of no more than 2 percent of GDP. The second component is the excess of the actual share of government spending in GDP over its permanent share. The third is the excess of the actual (inflation-and-growth-corrected) interest bill over the permanent interest bill (which is itself (long-run) inflation- and – (long-run) growth-corrected).

Good rules are simple and easily verifiable

The rationale for this requirement is obvious. Complex rules are likely to add noise and uncertainty to the system.

The Stability and Growth Pact (henceforth S&G) scores well on *simplicity,* although the medium-term balance rule involves cyclical adjustment, and the meaning of 'close to' balance is fuzzy.

The UK's sustainable investment rule is just as simple and easily verifiable as the debt rule of the S&G. The UK's cyclically adjusted golden rule involves both cyclical adjustment and a judgement about what constitutes public investment rather than public consumption – the funding of education and health are examples.

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[2] HM Treasury *Pre-Budget Report 2000: Chapter 02* 'Delivering macroeconomic stability'.

The Permanent balance rule is the most complex of the three sets of rules considered here. The principles behind it are straightforward but its implementation involves explicit judgementes about future plans for public spending, real interest rates and real growth rates.

Greater simplicity, however, is only a good thing other things being not too unequal. As will become apparent, the S&G rules are both simple and simply wrong much of the time. It is better to be approximately right than precisely wrong.

Good rules should ensure the solvency of the government.

Strictly speaking, only the Permanent Balance Rule has this property, and it has it by construction.

In practice, the S&G medium-term balance rule too virtually ensures government solvency. With the medium term budget is near balance or in surplus. and with positive medium-term nominal GDP growth and a positive outstanding stock of debt, the government debt-GDP ratio is bound to fall steadily in the medium term.

The UK's golden rule by itself is not guaranteed to ensure government solvency, although in practice it is likely to do so, unless government investment is a very high fraction of GDP indeed. Furthermore, the UK's sustainable investment rule acts provides further insolvency risk assurance, as it ensurea government solvency as long as the government is capable of sustaining a 40 percent debt-to-GDP ratio.

Good rules should not encourage pro-cyclical behaviour of the policy instruments.

Sensible fiscal rules do not have features that could lead fiscal policy to become pro-cyclical and thus to amplify the cycle rather than dampening it. The S&G

medium-term balance rule is a cyclically-adjusted rule and is consistent with the free and full operation of the automatic fiscal stabilisers, but only provided the starting value of the country's cyclically adjusted or structural deficit is indeed close to zero. The same holds for the UK's golden rule and the Permanent balance rule. The Permanent balance rule indeed allows for any shocks to and swings in public spending (wars) and/or revenue bases (earth quakes) that make for temporary deviations between current and permanent public spending shares. The S&G 60 percent of annual GDP gross debt ceiling and the UK's 40 percent of annual GDP net debt ceiling could become binding constraints and therefore could, if interpreted rigidly, interfere with the operation of the automatic fiscal stabilisers, whenever the cyclically appropriate deficit would push the debt above the ceiling.

The S&G three percent deficit ceiling in not cyclically adjusted. It therefore interferes with the operation of the national automatic fiscal stabilisers when the three percent ceiling is in danger of being breached by a cyclically appropriate increase in the deficit. This risk can be avoided by targeting a cyclically adjusted deficit that is sufficiently far below three percent of GDP. One, transitional problem with this solution is the problem of getting there from here. In 2001 (admittedly a cyclically weak year), the Euro Area as a whole had a 1.5 percent of GDP general government deficit which is too high to permit all members let their fiscal stabilizers operate freely. For many EMU members a period of further budgetary tightening would be required to move themselves into the safe zone. Many EMU members, including the three largest, missed the opportunity (taken by the UK)to run a tighter fiscal ship during the (relatively) high-growth years.

Good rules make sense also in the long run.

In a market economy with purposeful, forward-looking economic actors, the long run is now, in the sense that anticipations of future events, even quite distant ones, will shape current market prices and influence current actions. Fiscal rules should therefore not have anomalous long-run implications.

The S&G deficit rule and medium-term balance rule don't have an expiration date, or a provision for periodic revision. The same applies to the UK's golden rule and sustainable investment rule.

In the long run, the net debt to GDP equals the ratio of the long-run financial deficit to the long-run growth rate of nominal GDP. With a long-run nominal income growth rate of, say, 5 percent per annum, the long-run debt-annual GDP ratio implied by the S&G deficit rule (less than three percent) would be no higher than sixty percent. Nothing too anomalous here.

The S&G medium-term balance condition means that, on average over a long-run of years, the realised budgetary outcome is more likely to be a surplus than a deficit, the government will, in the long run, either have zero net debt or be a net creditor.

Does a creditor government make sense? It would be nice to be able to finance necessary public spending out of the income earned from the government's portfolio of financial assets rather than through the use of distortionary taxes. However, getting there from here would involve a transition with higher taxes or lower spending. Public debt is also a key government instrument for achieving intergenerational redistribution and insurance. Furthermore, there are also obvious problems with the compatibility of a private market economy with a government that is a large net creditor, holding a portfolio of loans, private bonds or even private equity. It is ironic

that the Stability and Growth Pact may have as one of its implications the partial socialisation of the means of production in the long run.

Under the Permanent Balance Rule, in the long-run (when the actual values of spending, growth rates and interest rates are the same as their permanent values), the government debt-GDP ratio is expected to be constant. The level at which it is constant is can only be determined by a consideration of the initial conditions and the entire history of the government deficit. The fact that the long-run debt-GDP ratio is *hysteretic*, or history-dependent under the Permanent Balance Rule may be troubling to some. If, on *a-priori* grounds, convergence of the debt-GDP ratio to a value below some critical threshold value is deemed desirable, the rule could be enhanced with a one-sided 'error correction' mechanism that drives the actual debt-GDP ratio down whenever it exceeds the critical threshold value. I will refer to such as rule as the Enhanced Permanent Balance Rule.

The UK's fiscal framework can be interpreted as a simplified practical approximation to the Enhanced Permanent Balance rule, with the (cyclically adjusted) Golden Rule capturing the permanent tax rate and the Sustainable Investment Rule providing a the threshold value for the debt-GDP ratio of 40 percent. Considering the experience of Belgium, Italy and Greece these past few decades, a threshold value of 40 percent is cautious, even conservative.

Under the *pure* Permanent Balance Rule, other things being equal, a higher debt-GDP ratio permits a larger financial deficit, rather than requiring a lower one. When the debt is nominally denominated, positive nominal income growth will, other things being equal, bring down the debt-GDP ratio, hence the need for an 'inflation and real growth correction' to the raw deficit figures. For any given growth rate of nominal income, a higher debt-GDP ratio means that the debt-GDP ratio will be

coming down faster. This is the opposite of the view expressed by the UK Treasury and more recently taken up by some members of the European Commission, that a higher public debt should imply a lower permissible deficit. The Enhanced Permanent Balance Rule with its 'error-correction' mechanism driving the debt-GDP ratio down to the threshold level, can be consistent with the view of the European Commission and the UK Treasury. It will be consistent provided the 'error correction mechanism', which measures the strength of the imperative to get the debt-to-GDP ratio down and reduces the permissible deficit, dominates the magnitude of the inflation-and-real-growth correction that increases the permissible deficit.

Good rules allow for relevant differences in economic structure and initial conditions.

The numerical constraints on deficits and debt of the Stability and Growth Pact are 'one size fits all'. What kind of heterogeneity matters for the performance of fiscal rules?

For any given capacity to generate future primary surpluses, a country can sustain a higher ratio of public debt in relation to its GDP, the lower its long-run real interest rate and the higher its long-run real growth rate. Also, for any for any given debt–GDP ratio, a country needs to generate smaller future primary surpluses, the lower its long-run real interest rate and the higher its long-run growth rate.

There are sizeable and persistent differences among the growth rates of the current 15 EU and 12 full EMU members. This inter-country variation in growth rates is bound to increase when the 10 early accession candidates join the EU in 2004. Eight of these countries are transition countries, former centrally planned economies from Central and Eastern Europe. Most of them are expected to go through a period of real convergence, or catch-up that may last for decades. It is thus to be both hoped

and expected that the long-run growth rate of the transition countries will be higher than that of the existing EU members.

Successful accession countries engaged in real catch-up can expect to see their real exchange rates appreciate relative to the existing EU members – the Balassa-Samuelson effect at work. If the accession candidate has a fixed nominal exchange rate with the euro (and a-fortiori if it becomes a full EMU member) near-equalisation of risk-free nominal interest rates will occur. Real interest rates will therefore be lower for this accession candidate than for the existing EU members. If something close to uncovered interest parity holds, the same will hold true even if the accession candidate does not have a credibly fixed exchange rate with the euro.

Another important source of heterogeneity relates to initial conditions, especially the outstanding stock of public infrastructure capital and the outstanding stock of debt. Despite recent rumblings about the need to take debt ratios into account, the operational S&G rules pay no attention to amount of debt outstanding. The S&G's three percent deficit ceiling applies equally to Belgium, Italy and Greece as to Luxembourg, Finland and Sweden. Yet, at the end of 2001, gross general government debt as a percentage of annual GDP was 108.2 for Belgium, 108.7 for Italy and 99.7 for Greece, while Luxembourg's scored 5.5 percent, Finland 43.6 percent, Sweden 52.9 percent.[3]

A low initial stock of social overhead capital, as found in the UK and in the transition countries scheduled for EU membership, is likely to imply the need for a period of high, 'catch-up' public sector investment. It would make no sense to insist that public spending that will yield benefits till far into the future be financed out of current revenues only. The S&G rules cannot handle this at all. The UK's golden

rule permits borrowing for (net) public sector investment, but presumably only up to the point where net general government debt hits the 40 percent of GDP limit of the sustainable investment rule. The permanent balance rule permits borrowing for public sector investment if and only if current public sector investment exceeds permanent public sector investment.

A final important source of heterogeneity relates to demographics and the financial condition of public pension systems. With greying populations and relatively generous state pensions, most continental EU members, and most of the transition countries about to join the EMU, will have to make hard choices between raising taxes, cutting state pension benefits (benefits or eligibility) or making cuts in other spending programmes. The future budgetary demands implied by current state pension schemes (if there were no change in benefit levels or eligibility and entitlement rules) are not reflected in any way in the S&G rules or in the UK's fiscal rules. They are, in principle, reflected fully in the permanent balance rule, where they would be captured by the gap between current public spending on pensions and the higher level of permanent (future) public spending on pensions.

Good rules make sense at the level of the individual nation state and for the EMU area as a whole.

All three rules influence and constrain each individual country's fiscal policy without any reference either to the fiscal actions of other E(M)U area members, or to the behaviour of the ECB and the other EU central banks. Nor do the rules take account of any past, current and anticipated future economic developments in the

[3] Source: OECD. Net general government debt as a percentage of GDP at the end of 2001 was as follows: Belgium: 98.9; Italy: 96.5; Finland: -47.9; Sweden: 1.0.

E(M)U area as a whole, e.g. the behaviour of output, employment, inflation and asset prices and the effective exchange rate of the euro.

The conditions are rare indeed under which it is for the members of an economic and monetary union to impose fiscal rules on each individual member country union that depend neither on the behaviour of the other national fiscal authorities, nor on the behaviour of the monetary authorities, nor on the aggregate economic performance of the union as a whole. The only obvious set of circumstances for which such an approach makes sense is when there are no international spill-overs. However, without international spill-overs there would be no rationale for having externally imposed fiscal rules in the first place, other than die-hard supranational paternalism ('we know what is good for you and you will do it, even though your failure to do what is good for you would have no detrimental impact on the other members of the club'). As there are indeed international spill-overs from national fiscal policies, it is virtually certain that the aggregation of one-country-at-a-time national fiscal rules will not result in desirable aggregate behaviour.

The informational and logistic modalities of co-ordinating the fiscal policies for 12 current EMU members, let alone for a possible 25 or more members of a future enlarged EMU, would be a nightmare. An intriguing 'market-based' decentralised mechanism for ensuring that the pursuit of unco-ordinated national fiscal policies results a sensible aggregate budget deficit for the EMU are as a whole has been proposed independently by Giorgio Basevi and Alessandra Casella [1999]. Borrowing from the environmental economics literature on tradable pollution permits, they propose the use of *tradable deficit permits* to allocate a given aggregate (EMU-wide) general government financial deficit efficiently among the constituent national governments. If national public debts are perfect substitutes in producing EMU-wide

aggregate public debt externalities, such as scheme would, *if it could be enforced*, distribute any given EMU-wide aggregate government financial deficit across the members states in an efficient, least-cost manner.

There are three key problems with the approach. First, while different countries' public debts may be perfect substitutes as regards producing 'normal' interest rate externalities , they are most unlikely to be perfect substitutes as regards systemic default risk externalities. The external damage done by an extra euro of debt issued by a financially fragile government is greater than that issued by a more prudent and clearly solvent government. Casella's proposal for determining the quantity of permits a country must purchase as a simple function of both its financial deficit and its debt-GDP ratio (as a proxy for financial vulnerability) does not represent an adequate treatment of differential default risk, as it ignores the capacity for generating primary surpluses, the growth rate and the interest rate as determinants of default risk.

Second, the scheme does nothing to solve the enforcement problem. Under the existing arrangement, it is extremely unlikely that the financial penalties that can in principle be imposed on countries exceeding the three percent deficit limit, will actually be imposed even if 'exceptional circumstances – severe recession' cannot be invoked. What happens under the permits scheme if a country issues debt for which it does not have a permit? Will the country issuing the unauthorised debt be fined? The purchaser of that debt?

Third, the analogy between pollutants and public debt is flawed. Pollutants are always a 'bad', never a 'good'; they impose negative externalities regardless of the quantity in the air. Public debt is not necessarily a bad, and the externalities imposed by one national government's debt on other national governments are not

necessarily negative. While negative systemic fragility (default risk) externalities are, other things being equal, likely to increase uniformly with the amount of debt issued by a country, ordinary interest spillovers are not. Higher (risk free) interest rates are not automatically worse than lower (risk-free) interest rates. Interest rate externalities are *pecuniary* externalities. Pure pecuniary externalities have distributional consequences but no efficiency implications. Higher interest rates are good for creditors, bad for debtors; good for savers, bad for enterprises contemplating capital formation. There are indeed other distortions in the economy that cause interest rate spillovers to have efficiency implications (e.g. distortionary taxes or costly revenue collection), but these spillovers can be positive and well as negative. The tradable deficit permit market might have to give way to a market in permits not to run a deficit.

Good rules are credible.

The need for a system of rules to be credible is both obvious and important. Rules can be simple and transparent, yet not credible. Unfortunately, the Stability and Growth Pact rules fall into that category.

For rules to be credible one of two conditions must be met. Either the rules are self-enforcing, or they are enforced consistently, through a combination of sticks and carrots, by an external agent. For rules to be self-enforcing they either must be individually incentive-compatible because they make sense at the level of the individual nation state, or they must take on 'totemic' or 'sacral' qualities.

The S&G three percent rule and medium-term balance rule are not self-enforcing by being individually incentive-compatible. It is clear that there are no 'spontaneous' or natural disasters that are bound to occur whenever a country

deliberately and systematically exceeds the three percent limit for its general government deficit. The number 3 is arbitrary, as are the numbers 60, 40 and zero (or the range near-zero). Those who proposed and defend the 3 percent deficit ceiling of the S&G Pact readily admit that they would have been happy with any number, as long as it was low.

As regards any totemic or sacral qualities for fiscal rules, there is, alas, little prospect of that in these secular and sceptical times. The Gold Standard had this rare 'totemic' or sacral quality for many decades before World War I, but failed to carry it into the inter-war period. Balanced budgets had totemic qualities until the Great Depression of the 1930s and the Keynesian Revolution. Argentina tried, in vain, to bestow totemic or sacral qualities on its one-for-one currency peg with the US dollar during the 1990s. None of the rules under review can expect help from the sub-rational recesses of the human mind.

The EMU is stuck with set of fiscal rules that are not credible. This creates a genuine dilemma for those who believe, as I do, that in a monetary union (and indeed beyond it) national fiscal policies can be a matter of common concern.

An optimal rule is credible, simple and transparent and flexible. Flexible need not mean opportunistic or weak. Credible need not mean rigid and inflexible. Commitment is not necessarily sacrificed when a rule is made contingent on observable, verifiable events or outcomes.

The problem with the current informal compromise amendment of the Pact that appears to be evolving - one violation at a time - is that there continues to be insufficient flexibility but there now also is too much scope for opportunistic, politically motivated manipulation of the framework and the process. There is no coherent conceptual framework to structure and focus the assessment of the likelihood

and significance of one or more of the numerical thresholds being exceeded. The conditions under which warnings will actually be issued and penalties will actually be imposed are obscure and intensely political. There is a risk that not only the Pact's numerical criteria are becoming discredited, but also the fundamentals notion of fiscal-financial sustainability and responsibility.

Good rules are enforced impartially and consistently.

All three rules need an impartial, consistent and competent enforcement mechanism. For the UK this is the Treasury. The Permanent Balance Rule (pure or enhanced) has not (yet) been adopted anywhere. The S&G rules are enforced in the first instance by the European Commission and in the final instance by the Ecofin Council. It is clear that this mechanism is not working.

The Commission has competence but does not have the necessary legitimacy as it consists of appointed civil servants with partisan political backgrounds. The Ecofin Council has the legitimacy. It may even have the competence, but it manifestly does not have the collective capacity to commit itself to an impartial, consistent enforcement of the rules.

It is obvious that fines for those who exceed the deficit or debt limits are a non-starter, because when they are imposed, they aggravate the budgetary imbalances they were expected to prevent or correct. Ex-post, that is, once a violation has occurred, the imposition of the fines is counterproductive. This makes them an ineffective deterrent ex-ante. The only potentially effective instruments currently available to induce compliance are moral suasion, peer pressure and 'naming and shaming'. A necessary, but not sufficient condition for this to be effective is that the

body that makes the determination of compliance or non-compliance has unquestioned moral and expert authority.

One possible option, for the EMU area, would be to give the task of determining compliance or non-compliance with the (thoroughly revised) fiscal rules to the six Executive members of the ECB Governing Council. While central bankers, like members of the Commission, are appointed bureaucrats without the political legitimacy that comes with elected office, they are generally perceived as less politicised in the partisan sense of that word.

Another option would be to let the National Academies of Sciences of the EMU members nominate (possibly by rotation) a group of experts to make the determination of compliance and non-compliance. They would serve for a fixed term, without possibility of re-appointment. This could be effective if the nominees owed their allegiance first and foremost to the mandate they would be given and to the canons of impartial scholarly judgement. Both proposals have obvious weaknesses (more rule by technocrats, to name but one) and are profferred only to stimulate debate.

It is unavoidable that persistent and deliberate non-compliance should trigger sanctions that bite, but they must do so without aggravating ex-post the problem they try to prevent ex-ante. No fines therefore. Consideration could be given to suspending the right of a country that has been judged to be in non-compliance, to participate and vote in Ecofin meetings until it has mended its ways.

Conclusion.

Fiscal rules in a monetary union should (1) be simple; (2) ensure the solvency of the state; (3) avoid pro-cyclical behaviour of the fiscal policy instruments; (4) make

sense also in the long run; (5) allow for key differences in economic structure and initial conditions; (6) aggregate into behaviour that makes sense at the level of the union as a whole; (7) be credible and (8) be enforced impartially and consistently.

The rules of the Stability and Growth Pact satisfy unambiguously only the first two of these eight requirements. They could be argued to satisfy the third, avoiding pro-cyclical behaviour also, as a country can take steps to have a public sector surplus that is large enough in normal times to eliminate the risk of hitting the deficit ceiling in unfavourable times.

A rethinking of the fiscal-financial framework for the EMU is necessary and urgent. Revising the Stability and Growth Pact will not be easy. Taking the long view, however, the cost of sticking with a deeply flawed set of rules is bound to dominate the short-term reputational damage caused by any significant redesign of the framework. A structured, well-thought-through process for revising the rules is bound to dominate the present spectacle of the rules experiencing slow 'death by a thousand cuts'. This review of the rules should be welcomed as an opportunity to re-emphasize and re-affirm the common purposes of fiscal-financial sustainability, efficient public financing and macroeconomic stability.

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