The Revised Stability and Growth Pact – A Critical Assessment

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The 2005 reform of the stability pact implies a radical watering-down of the EU fiscal rules as the scope for discretionary decision-making has been widened substantially. A cyclical improvement of public finances may only conceal the need to strengthen the incentives for fiscal discipline at the EU level. It is easy to outline how this could be done but the political prospects remain dim. One possibility might be to link changes in the monetary and fiscal policy frameworks in the EU to each other. Another is to strengthen incentives for fiscal discipline at the national level, for example through the establishment of independent fiscal policy councils.

The Stability and Growth Pact – the stability pact for short – has been seen by many as a cornerstone of the EMU. The stability pact complements and gives operational contents to the provisions regarding the excessive deficit procedure in the Maastricht Treaty. Together, the pact and the procedure regulate how the EU system should deal with countries having fiscal deficits above three per cent of GDP or not fulfilling the treaty obligations on government debt (a debt-to-GDP ratio of less than 60 per cent or if the ratio is higher that it should be declining). The rules stipulate gradually escalating measures to induce a country with an excessive deficit to take corrective action: the scale starts with a recommendation from the Ecofin Council and ends with the possible imposition of fines (for those countries that have adopted the euro).

The aim of the EU fiscal rules is to counterbalance the *deficit bias* that is a feature of fiscal policy making in many modern democracies. This bias was very evident in most EU countries in the 1975-95 period, which was characterised by large budget deficits and increasing government debt. It has been a common worry that the deficit bias could be exacerbated in the monetary union, where part of the costs of fiscal profligacy in one member state may have to be borne by the other states.

The excessive deficit procedure was invoked for the first time in the monetary union in 2002, when it was applied for Portugal. But already in 2003 the pact was thrown into a crisis when the Ecofin Council did not follow the stipulated procedures for Germany and France, which both had begun to run deficits above three per cent of GDP in the preceding year. This led to a situation where it was very unclear what rules did in effect apply. The stalemate was "resolved" through a reform of the stability pact in 2005, which introduced a number of changes. Today, the deficits in six of the old EU members (in addition to Germany and France, also Greece, Italy, Portugal and the UK) and in six of the new ones (Cyprus, the Czech Republic, Hungary, Malta, Poland and the Slovak Republic) have been classified as excessive by the Ecofin Council.

This short article assesses the consequences of the stability pact reform and discusses various possibilities of restoring stronger incentives for fiscal discipline. The analysis builds on a more extensive assessment in Calmfors (2005).[1]

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[1] See also Buiter (2005) and Wyplosz (2006) for other recent assessments of the stability pact reforms.

An assessment of the revised stability pact

There exists a positive interpretation of the revisions of the stability pact.[2] According to this view, the reform of the stability pact has introduced more room for sensible judgement, at the same time as the fundamental rules, in particular the three-per-cent deficit ceiling, have been saved. Although some changes work in the direction of loosening the pact, they may be counterbalanced by others. It is also maintained that increased flexibility may increase the legitimacy of the pact and therefore make it easier to enforce. This optimistic view takes comfort from the fact that the revisions of the stability pact have not yet triggered any adverse reactions in financial markets.

Also, according to this line of reasoning, the short-term prospects appear rather bright. The budgetary situation is likely to improve in the current cyclical upswing in most eurozone countries, including those with excessive deficits. And most importantly, the new government in Germany has embarked on a path of budgetary consolidation, which will again make Germany interested in upholding the fiscal rules ("restoring German ownership of the stability pact" in the EU jargon used).

It is true that some of the changes in the stability pact – for example, formulations on an increased emphasis on the debt criterion and on a "commitment" to enhanced budgetary discipline in good times as well as provisions on "minimum fiscal efforts"– may help strengthen fiscal discipline. But these changes apply mainly to the *soft* parts of the pact, that is those that concern mechanisms for avoiding that excessive deficits arise in the first place (the "preventive arm" of the pact). The most important changes are those that apply to the hard parts, that is to the excessive deficit procedure and the ultimate use of sanctions when large deficits have already arisen (the "corrective arm").

The crucial changes are the new possibilities for the Ecofin Council to extend the *deadlines* for correcting excessive deficits if this is judged as motivated after consideration of a number of "other relevant factors". These include a very mixed bag consisting of "potential growth", "prevailing cyclical conditions", "the implementation of policies in the context of the Lisbon agenda and policies to foster R&D and innovation", "fiscal consolidation efforts in good

[2] See, for example, *Public Finances in EMU* (2005), Buti and Franco (2005) or Buti, Eijffinger and Franco (2005).

times", "debt sustainability", "public investment" and "the overall quality of public finances" as well as "any other factors that in the opinion of the Member State concerned are relevant". The latter factors have been exemplified with "budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe".[3]

Table 1 shows that, compared to the original stability pact, there could be a maximum extension of the deadline by three years (the fourth column) or even by four years (the fifth column) if one were also to use the new possibility not to classify a deficit above three per cent of GDP as excessive when it first arises. The implication is that a deficit above three per cent of GDP in year *t* need not be corrected in year *t+2*, as was originally envisaged, but first in year *t+5* or possibly in year *t+6*. This postpones also the dates when the country in question can be required to pay a deposit and when the deposit can be converted into a fine. The dates for fines are moved from year *t+5* to year *t+8* or year *t+9*.

This represents a very significant watering-down of the pact. The problem is the widening of the scope for *discretionary decision-making* in the enforcement process. This goes very much against the original German proposals on the pact in the mid 1990s, which advocated that sanctions should be more or less automatic in order to circumvent the political process. The idea was that sanctions would be imposed unless there was a majority in the Ecofin Council *against* doing so.[4]

The motive behind the establishment of the EU fiscal rules in the first place was to institute rules to constrain discretionary decision-making at the national level. Widening the scope for discretionary decisions in the enforcement procedures means that the rules become less binding for national budgetary decision-making. The implication is a large step back in the direction of discretionary fiscal policy making at the national level, which was the problem that the rules were designed to address.

The root of the enforcement problem with the EU fiscal rules is the strong incentives of finance ministers in the Ecofin Council to act strategically and *collude* to avoid sanctions for violators of the fiscal rules. This has partly been the result of several countries running large

[3] The quotations are from Ecofin Council Regulation 1056/2005.
[4] See Stark (2001) for an insider account of the "birth" of the stability pact in 1995-97.

deficits at the same time. But also finance ministers in countries without deficit problems have a strong incentive of treating colleagues in countries with such problems in a lenient way: this can be regarded as an investment, raising the probability that they themselves will be treated in a similar lenient way were they, too, to run large deficits in the future. It cannot then be the solution to increase the scope for discretionary decisions even further; this can only aggravate the enforcement problem.

But the worst problem is not the actual changes made in the stability pact. It is the demonstration that the rules are *endogenous*: they are likely to be changed in response to violations that have occurred, at least if the violations have been made by large countries. This represents a very major *credibility loss*. Why should one not expect the same thing to happen again if the new looser rules are also violated?

The situation in the coming years

A counter argument to my reasoning is that budget deficits are likely to be reduced in the coming years. This is true. But deficits are not likely to be reduced enough. We will probably see a repetition of earlier experiences, where fiscal policy is not tightened sufficiently in a cyclical upswing. It is commonly acknowledged that most of the deficit problems in the EU countries have their origins not in the policies pursued during downswings but in the policies pursued in the preceding upswing. [5]

What about the current deficit reductions in Germany? Does not that mean that adherence to fiscal discipline will be restored? Unfortunately, much of the credibility loss has already been suffered. In sum, Germany has obtained a three-year extension (till 2007) of the original deadline (2004) for correcting its excessive deficit. This is the maximum according to the new rules, so it means that a very lax precedent has been set for the future. In fact, one has probably gone even beyond the new rules, as the requirement for such a long extension should be the occurrence of “unexpected adverse events”, which is hard to argue in the German case. In a strictly formal sense, it is not a violation of the revised pact since this requirement refers to repetitions of a recommendation or a notice from the Ecofin Council, which have not taken place for Germany. Instead, the extension derives from the phasing-in of Germany into the revised pact. But still there is a *de facto* violation of the new rules. It would not help much

[5] See, for example, Buti and Franco (2005), Buti, Eijffinger and Franco (2005) or Wyplosz (2006).

even if Germany were to reduce its deficit below three per cent of GDP already this year since the damage has already been done. It is extremely unlikely that it will in the future be possible to treat other countries more strictly than Germany was *ex ante*.

There is also another serious problem with the German case. For an outside observer it looks very much as if a precondition for the last step taken in the excessive deficit procedure against the country – the notice given by the Ecofin Council in March 2006 – was that the German government agreed to it beforehand. This is close to establishing a principle where perpetrators – at least if they are large countries – are given a *de facto* right to *veto* later steps in the excessive deficit procedure against them, so that it is not allowed to pass a certain point without consent from the country concerned.

The lax treatment of Germany comes on top of a lenient treatment of Portugal and Italy, which have both, after the adoption of the new rules, been given extended deadlines (three years instead of two) to correct their excessive deficits.

My discussion leads me to the conclusion that improving budget positions in the short term in the EU countries may not be much of a cause for optimism. A limited improvement in a cyclical upswing could even have the adverse effect of deceiving many people into believing that the reformed rules are effective. This might serve as an excuse for complacency, which is likely to exacerbate the problems later on instead.

Possible improvements of the stability pact

From a *technical* point of view, it is easy to point out how the enforcement of the fiscal rules could be improved. If the problem is the political decision-making among EU finance ministers, the obvious solution would be to *depoliticise* the enforcement decisions. One proposal is that decisions in the excessive deficit procedure would at some stage be transferred from the political level of the Ecofin council to the judicial level of the European Court of Justice.[6]

However, it is politically very unrealistic to expect such a depoliticisation of the enforcement procedure: politicians are clearly unwilling to give up their current control of it. The

[6] See Calmfors and Corsetti (2003) and EEAG (2003).

alternative would then be to strengthen the incentives for enforcement in the political process among finance ministers. A rather obvious improvement – again from a purely technical point of view – would be to deny member states with excessive deficits the right to vote in the excessive deficit procedures against other countries, as this would make it harder for the "sinners" to collude.

Another issue concerns the severity of sanctions. One reason why politicians have shun them is that they may be perceived as too harsh. It is also a peculiarity that the deposit (fine) associated with a given excessive deficit is higher in the first than in subsequent years (unless the deficit is very large: above seven per cent of GDP). This can be seen from Table 2, which shows how large the deposits (fines) will be in different years depending on the size of deficits.[7] The front-loading of the sanctions probably deters politicians from using them. The chances would be larger if the sanctions were initially smaller and then gradually increased over time instead.

One could even question the wisdom of applying pecuniary sanctions at all. A common "folklore" objection against them is that fines will exacerbate the deficit problems they are supposed to counteract. This is likely to weaken the legitimacy of the sanctions. It is an argument for contemplating non-pecuniary sanctions instead, for example a gradual loss of voting power in general in the Ecofin Council.

The balance between fiscal and monetary policy

It is very difficult to see how reforms of the type discussed above could be politically feasible within the foreseeable future. After the "traumatic" conflicts regarding the treatment of Germany and France under the old fiscal rules and the difficulties of agreeing on a revised stability pact, politicians do not want the issue on the table again. Another obstacle is the stalemate regarding the EU Constitution. In addition, the cyclical improvement in fiscal balances that can be expected over the coming years will in all probability reduce the perceived need to strengthen incentives for fiscal restraint, as argued above.

[7] In the first year that a deposit (fine) has to be paid it consists of a fixed component of 0.2 per cent of GDP and a variable component that increases with the size of the deficit (0.1 per cent of GDP for each whole percentage point excess of the deficit-to-GDP ratio over three per cent). In subsequent years, there is only the variable component. In each year, the deposit (fine) is maximised to 0.5 per cent of GDP.

The long-run consequence of the weakening of the stability pact is likely to be an unfortunate balance between monetary and fiscal policy. Lax fiscal policy will induce a more contractive monetary policy on the part of the ECB than would otherwise be the case. And such a monetary policy will weaken the incentives of governments to make fiscal policy less expansionary. The eurozone risks becoming trapped in a bad equilibrium with high interest rates and large budget deficits, which will be very unfriendly to growth.[8]

As is well known, also the monetary policy framework of the ECB has been subjected to a large amount of criticism. The price stability goal of inflation "below but close to two percent" has been criticised for being too low: it makes real exchange rate adjustments inside the euro area difficult and implies large risks of ending up in a liquidity trap in a severe downturn. The monetary policy framework has also been criticised for being non-transparent, especially regarding the importance attached to monetary developments. One could therefore argue that it would be desirable to reform *both* the fiscal and the monetary policy frameworks in the EU and to link these reforms to each other. In a long-run perspective, this might be one of the few politically feasible ways of restoring a more stringent fiscal policy framework at the EU level. The desirable timing – in order to reduce the risk that the reforms would only result in a more permissive attitude to inflation – would then be for governments to take the *first step* by restoring stronger incentives for fiscal discipline. In a *second step,* the ECB could then "reward" governments through reforms of the monetary policy framework implying more transparency and a symmetric inflation target of say 2.5 or 3 per cent. But if the proper reform incentives for governments are to be created, such co-ordinated reforms would require an *ex ante* understanding that the ECB would reciprocate in this way.

National fiscal policy committees

However, if one makes a realistic appraisal, one has to be sceptical about the possibilities of restoring well-functioning fiscal rules at the European level. The basic reason is that the European Union may not in the end have the legitimacy required to uphold supranational fiscal rules. The conclusion is then that it might be better to focus the attempts at establishing incentives for fiscal restraint at the national level instead.

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[8] This risk has been analysed in a large number of contributions. See Buiter (2005) and EEAG (2006) for two recent examples.

Governments usually formulate sound principles for budget policy. The problem is that their incentives to follow these principles often are weak. One idea for strengthening these incentives is to establish national *fiscal policy councils,* consisting of independent experts, which could be given the task of monitoring that *ex post* government budget policy is consistent with *ex ante* formulated objectives.[9] Such a council could be given a formal role in the annual budget process: it could give recommendations on the appropriate fiscal policy stance to which the government could be obliged to respond formally in the parliament, it could supply the forecast forming the basis for the government budget proposal (so as to avoid an “optimism bias”) and it could make an evaluation of the final budget proposal that could serve as the basis for the parliamentary discussion of it. The idea would be to increase the transparency of the budget process, so that the reputation costs of bad fiscal policy would rise and voters could more easily hold the government accountable.

It has proved possible to eliminate the inflation bias of monetary policy by delegating it to independent ”technocrats”. It would be much more problematic to delegate fiscal policy in a similar way to counteract the deficit bias, as fiscal policy is intertwined with income distribution concerns where value judgements are crucial. In contrast, the monetary policy objectives of low inflation and output stabilisation are more universally accepted. However, there is a much stronger case for establishing *countervailing powers* in fiscal policy making by giving an independent council a role to speak up on deficit and debt developments.

Proposals of this kind are, of course, also politically very unrealistic at least in a short-term perspective. They usually meet with strong resistance from politicians. However, one has to acknowledge that the EU fiscal rules have lost their bite. Things could look a little bit better for some time to come, as there is likely to be a cyclical improvement in public finances in many EU countries. But this may only conceal the underlying long-run problems. If this is so, there is a need to find other ways of strengthening fiscal discipline. It will just not do to dismiss *all* ideas of how this could be done. In the end, European politicians will have to address these issues again. But we may have to wait for quite some time before the need for this will be clearly perceived.

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[9] Such proposals have been formulated by, for example, Calmfors (2003, 2005), EEAG (2003), Jonung and Larch (2004) and Wyplosz (2005).

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Table1: Theoretically possible scenarios for the excessive deficit procedure in case of non-compliance (time until first fine)

Year	Old pact as originally envisaged and strict application of new pact	Lax application of new pact	Very lax application of new pact	Super-lax application of new pact	Maximum laxity according to new pact
t	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP
t+1	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Excessive deficit exception
t+2	Deadline for correction				Council decision on excessive deficit and recommendation
t+3	First deposit	Extended initial deadline	Extended initial deadline	Extended initial deadline	
t+4	Second deposit	First deposit	Repeated recommendation and new extension of deadline	Repeated recommendation and new extension of deadline	Extended initial deadline
t+5	First deposit converted into fine	Second deposit	First deposit	Repeated notice and further extension of deadline	Repeated recommendation and new extension of deadline
t+6		First deposit is converted into fine	Second deposit	First deposit	Repeated notice and further extension of deadline
t+7			First deposit converted into fine	Second deposit	First deposit
t+8				First deposit converted into fine	Second deposit
t+9					First deposit converted into fine

Note: The table has been constructed under the assumption that a deficit above three per cent of GDP is identified the year after its occurrence. Later identification would lengthen the period before fines should be imposed according to the new rules.

Table 2: The size of deposits/fines

Deficit (per cent of GDP)	**Deposit/fine (per cent of GDP)**	
	Year 1	**Subsequent years**
3-4	**0.3**	**0.1**
4-5	**0.4**	**0.2**
5-6	**0.5**	**0.3**
6-7	**0.5**	**0.4**
7-	**0.5**	**0.5**