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HOW TO REFORM EUROPE´S FISCAL POLICY FRAMEWORK

by

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The current budgetary problems of some EU member states have intensified the debate on Europe's fiscal policy framework. It is not enough to change the interpretation of the Stability and Growth Pact. More fundamental revisions of the EU Treaty are needed in order to strike a reasonable balance between long-run sustainability and short-run flexibility. The ceiling on budget deficits should be conditioned on the government debt level, such that the scope for stabilisation policy in downswings is increased in low-debt countries. In addition, the enforcement of the rules should be depoliticised: decisions on sanctions against states violating the rules should be transferred from the political level of the Council of Ministers to the judicial level of the European Court of Justice.

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The current budgetary problems in some member states of the European Union, such as Germany, Portugal, France and Italy, have intensified the debate on the fiscal policy framework at the European level. Proposals on how to reform the framework abound. Some commentators have also proposed that the current EU fiscal rules should be abandoned altogether.

1. The current fiscal rules

The fiscal rules in the EU consist mainly of the provisions in the Maastricht Treaty on the so-called excessive deficit procedure and the Stability and Growth Pact (the stability pact for short below). The Treaty sets out the basic stipulations, whereas the stability pact defines their operational contents. The main rules are as follows:

- The Treaty sets a deficit ceiling of three per cent of GDP for the actual government budget balance. Larger deficits are considered ”excessive” unless quite stringent exceptionality clauses are met. If a member state in the monetary union (EMU) does not take corrective action to eliminate an excessive deficit, it is required to pay an interest-free deposit of up to 0,5 percent of GDP. If the excessive deficit persists, this deposit will be converted into a fine, which is distributed among the other EMU member states.
- The Treaty also stipulates that gross government debt should be below 60 percent of GDP. If it is higher, it must be ”decreasing at a satisfactory pace”. No escape clause is associated with this stipulation, but there are no sanctions in the case of violations.
- According to the stability pact, countries should aim for a ”medium-term” budgetary position of ”close to balance or in surplus”. To ensure compatibility with this objective, there is a process of multilateral budgetary surveillance, according to which the Ecofin Council (the Council of EU finance ministers) can issue so-called early warnings to member states that are judged not to exercise enough fiscal discipline.

There have been many types of criticism against the fiscal rules. A common criticism is that the budgetary objectives and constraints lack theoretical foundations and are too ambitious. Another criticism is that the deficit and debt measures used are arbitrary. With respect to macroeconomic stabilisation, two main objections have been raised. The first is that the fiscal rules may hamper stabilisation efforts in downswings, as now appears to be the case in Germany. A second objection is that the rules provide insufficient incentives for fiscal restraint in booms by not rewarding such policies enough. It has also been argued that the current rules put too much emphasis on the current government budget balance and too little on the government debt position. Finally, a different type of criticism has emphasised the difficulties of applying the sanction procedures in concrete situations because of the political conflicts among member states that are likely to arise.

2. The European Commission's reform proposals

How should one regard the rules? In our view, they have played a useful role for strengthening fiscal discipline in Europe. At the same time, it should be acknowledged that the fiscal rules were instituted in a specific historic situation. There was an urgent need in the 1990s for reversing the trend of rapidly accumulating government debt and to quickly establish credibility for the euro in its initial phase.[1] But once the monetary union has been shown to work, there is a case for refining the rules. However, this must be done in such a way that the reforms are not perceived as accommodating the current budgetary problems of some EU member states, which would undermine the credibility of any future EU fiscal rules.

Most proposals on reforms of the fiscal policy framework suggest a reinterpretation of the stability pact, but try to avoid a revision of the Treaty. This is, for example, the case with recent proposals from the European Commission, which aim at introducing more flexibility regarding the medium-term fiscal objective and giving greater importance to the government debt situation (European Commission, 2002a).

More precisely, the recent proposals from the Commission include the following items. It should be stipulated explicitly that the medium-term budget target applies to the cyclically adjusted and not the actual budget balance, so as to make it clear that there is

[1] For a thorough analysis of the economic rationale for these rules, see Buiter *et al*. (1993).

room for the automatic stabilisers to work over the cycle. A procyclical loosening of fiscal policy in booms should be considered a violation of the budgetary requirements. The interpretation of the stipulation that the government debt ratio should be "decreasing at a satisfactory pace" if it is above 60 percent of GDP should be clarified and "a failure on the part of a high-debt country to achieve the established pace of debt reduction" should lead to an activation of the excessive deficit procedure. Member states with government debt below 60 percent of GDP could be permitted small temporary deviations from the "close to balance or in surplus" requirement for the cyclically adjusted budget balance, if such a deviation derives from "a large structural reform" aiming at promoting employment or growth. Finally, "small deviations of a longer-term nature" from the medium-term budget objective could also be allowed for countries with very low debt ("well below the 60 percent reference value).

We endorse the clarification of the medium-term objective and a greater emphasis on the debt change criterion. We see, however, two major problems with the Commission's proposals. One is the increased complexity of the rules and the amount of discretionary judgements envisaged. The lack of transparent rules involve a serious danger of more lax fiscal discipline, as almost any reduction in taxes or increase in government expenditures can be argued to be beneficial for growth. Second, a loosening of the objective for the cyclically adjusted budget balance without changing the deficit ceiling reduces the budgetary safety margins and thus increases the risk that the ceiling is breached. This will in the end make it more difficult to uphold the respect for the deficit ceiling.

3. A better plan for reforming the fiscal rules[2]

In our view, the proposals of the Commission are insufficient and potentially harmful. More radical reform involving Treaty revisions are necessary. Such reform should focus directly on the deficit ceiling and the excessive deficit procedure, which form the backbone of the EU fiscal rules. The changes in the rules should be clear and transparent. Our proposal is to condition the deficit ceiling explicitly on the debt level, allowing low-debt countries to run larger deficits in downswings than high-debt countries. The main

[2] Our proposals are described in greater detail in EEAG (2003). See also Calmfors and Corsetti (2002).

motivation for such a debt-deficit link is that a main benefit of low government debt should be to enhance the room for manoeuvre in stabilisation policy. This can be seen as a corollary to the common argument that a track record of low inflation for a central bank should increase the scope for interest rate cuts in a downswing. A debt-deficit link would also have other advantages:

1. The incentive for fiscal restraint in general is enhanced if the returns to such policies, in the form of greater scope for stabilisation policy in downswings, become higher. Even if it is a future government that would enjoy the advantage of greater freedom of action in stabilisation policy, it becomes more visible to the general public that the incumbent government has made an investment that represents a future gain.
2. The stronger incentive for fiscal discipline implies a smaller risk of procyclical policies in booms.
3. To the extent that the advantages of fiscal discipline become larger, the legitimacy of the fiscal rules, and thus their long-run credibility, would be enhanced.

One possibility would be to stipulate different deficit ceilings for different debt intervals. An example of such a ladder of deficit ceilings is proposed in Table 1, according to which a lower debt ratio than 55 percent would permit successively higher deficits than three percent of GDP. As can be seen, we have deliberately chosen the intervals so that the current scope for deficits would not increase in France, Germany, Portugal and Italy, which at present all have budget problems. In the present situation the deficit ceilings would increase only for Luxemburg, Ireland, the UK, Denmark, Sweden, and Ireland. Since the accession countries to the EU in general have lower debt ratios than the incumbent member state, our proposed rule would give them greater scope for deficits in downswings, which can be motivated by the risk of larger cyclical swings during their transition to more developed market economies.

An alternative technical set-up would be to retain the present three-percent deficit ceiling, but allow countries to use extra-budgetary "rainy-day funds" (of the type that exists in many US states and Canadian provinces) that are not formally included under the deficit ceiling.[3] A system of such funds could be constructed so as to mimic the debt-deficit link in Table 1. One possibility is to let countries with government debt below certain thresholds establish such stabilisation funds immediately through borrowing or by transferring government claims on the private sector to them. Another more demanding option is to let low-debt countries build up the funds over time by channelling government surpluses into them in good times.

A system of extra-budgetary stabilisation funds would formally maintain the three-percent ceiling as a point of reference. This might be considered an advantage, as this budget constraint has come to be common knowledge. Extra-budgetary stabilisation funds might also help earmarking government revenues in upswings only for stabilisation purposes in downswings. Arguably, however, a system of extra-budgetary funds is less transparent than a system that explicitly conditions the deficit ceiling on the debt level.

4. A golden rule should be avoided

It has been argued that the EU fiscal rules should be changed by introducing a so-called golden rule, according to which deficit financing of public investment is allowed, as is the case, for example, in the UK (see Blanchard and Giavazzi, 2002, for a recent exposition of the argument). The motivation is a fear that the current fiscal rules crowd out public investment. A pragmatic argument in the current situation is that such a change would mean a loosening of budgetary objectives and a slower reduction of government debt. This would not seem advisable in a situation where the future demographic development will impose budgetary strains in most EU member countries. On the contrary, continued reductions in government debt over the next 10-20 years, and thus in interest payments, is a good way of smoothing the tax rises that would otherwise be necessary to pay for an ageing population.

There are also more fundamental objections against a golden rule. The theoretical justification for it is that public investment generates future tax revenues. There are, however, many public investment projects that are socially desirable, but where the future

[3] Such extra-budgetary stabilisation funds have been discussed in the EU context by, for example, Buti *et al.* (2002).

additions to tax revenues fall short of the interest costs of additional debt. From a more practical point of view, proponents of a particular investment project have strong opportunistic motives to inflate the estimates of future revenues. Moreover, there is no theoretical reason why a golden rule should apply only to physical capital investment, but not to investment in human capital or to other expenditure increases or tax reforms that will generate future revenues. But extending a golden rule in this way would make it impossible to operate: the political-economy risks that fiscal laxity could then always be justified would simply be unmanageable.

All this is not to deny that public investment may have fallen below efficient levels in many European countries. The political-economy reason for this is that interest groups fighting cuts in public investment are not so strong and vocal as interest groups opposing cuts in current transfer programmes. But this is not an argument to relax budget goals. What is called into question is instead the political priorities in the budget process.

5. The enforcement of the fiscal rules should be depoliticised

Defining the fiscal rules at the European level is one thing. As, for example, the experience in 2002 showed, when the Ecofin Council did not issue the early warnings to Portugal and Germany recommended by the Commission, applying the rules in practice is quite another thing.

A fundamental problem is the political character of EU decisions regarding the budget situation in individual member states. The finance ministers in the Ecofin Council have a strong incentive to act strategically as the budget surveillance and excessive deficit procedures can be viewed as a repeated game: by adopting a forgiving attitude towards colleagues with deficit problems, the risk of being branded oneself in similar situations in the future is reduced.

The root of the problem is that EU monitoring of fiscal situations in individual member states is in the end done by the politicians responsible for these very situations. This is an unsatisfactory state of affairs. Our political systems usually draw a sharp dividing line between making the laws (which is done by elected politicians) and applying them (which is done by an independent judiciary). The budgetary surveillance and excessive deficit procedures clearly violate this principle.

The European Commission has proposed that it alone should be given the power to issue early warnings in the budgetary surveillance procedure. A potential problem with this proposal is the current weak political legitimacy of the Commission. Still, the proposal is a better alternative than the present arrangement. But a similar solution would seem less preferable in the case of the excessive deficit procedure. Here, a possibility could instead be to transfer the decisions on sanctions from the political level of the Council to the judicial level of the European Court of Justice. The natural procedure would then be for the Commission to take violations of the excessive deficit criterion to the Court, which would then make the ultimate decisions on fines, possibly after hearing a standing panel of independent economists. Special procedures would then have to be followed to ensure a speedy process, which is necessary in order to create the proper incentives for avoiding excessive deficit situations.

6. Conclusions

Our two proposals of making the deficit rules more flexible and revising the decision process on excessive deficits may appear unrelated. In fact, they are not. The more credibly the fiscal rules are enforced, the greater is the scope for changes that introduce more flexibility.

In our view, it is necessary to modify the EU fiscal rules if they are to retain their legitimacy. In doing this, two dangers must be avoided if the credibility of the rules is to be preserved. First, reforms must be bold enough such that one can avoid repeated changes in the rules, which would create the impression that they can continuously be tinkered with. Second, policy makers must resist the temptation to change the fiscal policy framework in such a way that the current budgetary problems of some EU member states are accommodated: it is not a good strategy to try to solve short-run problems by adjusting long-run rules. The insufficient fiscal retrenchment in these member states in the preceding upswing means that there does not exist any ”quick fix” for the current situation. It is better then to focus on making the fiscal policy framework viable in the long run.

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Table 1: A possible way of letting the deficit ceiling depend on the debt ratio

Debt ratio (percent of GDP)	Deficit ceiling (percent of GDP)	Countries in the range (debt ratio in parenthesis)
> 55	3.0	Italy (108.0), Belgium (101.7), Greece (102.0), Portugal (58.1), *Bulgaria* (58.1), France (59.3), Germany (61.8), Austria (63.0)
45 - 55	3.5	Netherlands (50.1), Sweden (51.7), *Hungary* (52.9), Spain (53.2)
35 - 45	4.0	Ireland (35.0), UK (38.1), *Slovak Republic (39.3)* Finland (41.9), Denmark (42.4), *Poland* (43.3)
25 - 35	4.5	*Czech Republic (25.6), Slovenia (27.9)*
< 25	5.0	Luxembourg (3.9), *Estonia* (4.4), *Latvia* (16.8), *Lithuania* (23.6), *Romania* (24.6)

Note: Accession countries in italics. For these countries the debt data refer to 2002, for the incumbent member states the data are Commission forecasts for 2003.

Source: European Commission (2002b,c,).