"Lax budget policy in the EU is a threat to the Swedish economy"

A weakened stability pact requires stronger restrictions on the Swedish government. The attempts to secure sound government finances in the EU countries have failed through the weakening of the stability pact. A lax and opportunistic budget policy risks spreading throughout the European Union. This applies to Sweden, too, where the government is already "justifying" departures from its budget objectives with the argument that the situation is even worse in other countries. When the EU's regulatory system is undermined, strong national countermeasures are required. The government could, for instance, be charged with basing its budget calculations on assessments made by an independent council of fiscal policy experts. These views are put forward by Lars Calmfors, professor of economics and expert on the EMU.

The stability pact has been a mainstay of the economic policy cooperation within the EU. The pact consists of rules aimed at maintaining budgetary discipline in the member states. However, the reforms recently decided by the EU finance ministers will in practice completely undermine the regulatory system. So there is good reason to analyse what happened.

The original motive behind the EU's fiscal policy rules was a fear of rapidly mounting government debt. There is a strong temptation for governments to behave short-sightedly and not take into account the negative long-term effects of large budget deficits. These can push up interest rates, which crowds out investment and reduces growth.

The worst possible scenario is that a country finds itself in an untenable spiral with such large government debt that doubts arise regarding its ability to meet interest and amortisation payments. The lenders then demand higher rates of interest, which leads to the debt growing at an even more rapid pace and to interest rates rising further, and so on. It is usually only possible to get out of such a situation through very drastic budget cuts, which have very negative welfare effects.

Within the euro area, an untenable development in government finances in some member states will also entail considerable risks for the others. Pressure may be put on the European Central Bank to allow higher inflation throughout the euro area in order to reduce the real value of outstanding government debt in countries suffering problems. If one government is unable to meet its amortisation and interest payments, lenders in the other member states will also suffer large losses.

The EU's fiscal policy rules were established in the light of earlier problems with government finances. During the period 1980 to 1995, public sector debt as a percentage of GDP increased for the EU as a whole from around 40 per cent to approximately 75 per cent and some countries (Belgium, Greece and Italy) notched up debt ratios of more than 100 per cent.

The main contents of the fiscal policy rules can be summarised into four points:

* A government budget deficit ceiling of in principle 3 per cent of GDP. Breaches can lead to fines.

* A maximum debt ratio for the public sector of 60 per cent of GDP or, if the debt ratio is above this level, a requirement that it shall be reduced "at a satisfactory pace".

* On average over the economic cycle the budget shall “be close to balance or in surplus”.

* All EU member states shall regularly provide economic policy reports (stability or convergence programmes) to the EU, for evaluation by both the Commission and the Ecofin Council (the EU’s finance ministers).

The major changes now agreed by the EU’s finance ministers refer to the exceptions that can be made from the three per cent limit for budget deficits. Previously, no excessive deficit procedure was launched against a government if GDP fell by at least 0.75 per cent during one year. Now any negative growth at all will suffice to avoid the excessive deficit procedure, as will a protracted period of “very low growth relative to potential growth”.

However, what has aroused the most attention is the reference to “other relevant factors” that could motivate an exception. These include, for instance, “policies to foster R&D and innovation” as well as “public investment and the overall quality of public finances”. The most far-reaching new provision is that all factors "which *in the opinion of the Member State concerned* are relevant” (my italics) should be given “due consideration”. Examples given here are financial contributions to “fostering international solidarity” (read foreign aid and perhaps even defence expenditure) and ”achieving European policy goals, notably the unification of Europe” (read expenditure for the German reunification and perhaps also net contributions to the EU’s budget as well as contributions to promote other objectives that are considered important).

The wording of the finance ministers’ agreement is evidently so elastic that they will always be able to justify exceeding the three per cent limit.

The agreement also contains some attempts to tighten up the rules. For instance, the EU’s finance ministers are to draw up recommendations as to how countries with a public debt in excess of 60 per cent of GDP should reduce it. Moreover, member states are encouraged to discuss in their national parliaments both the reports presented to the EU and any EU recommendations on what policy should be conducted. The possibility of sanctions against countries that cheat in their budget statistics is also taken up. However, the proposals for tightening the rules are vague and non-binding, while those for loosening up the rules will be written into EU legislation according to the agreement.

In formal terms, it can be claimed that the loosening of the stability pact is limited, as the exemptions described will only apply if the three per cent limit is exceeded on a temporary basis and if the deficit is “close” to the limit. However, this argument completely misses the point.

The problem is that the stability pact is being adapted to the contraventions that have occurred. The earlier rules were designed to counteract opportunistic behaviour by governments. But when the rules functioned in the intended manner, the French and German governments forced through changes in order to avoid criticism and sanctions that might coincide with upcoming elections. The consequence of this will be low credibility for the new rules, too. Why should they be respected if the old ones were not?

The dismantling of the stability pact reduces the legitimacy of the EU. It sometimes seems as though the EU brings out the worst side of politics; abandoning the principles you have actually agreed on as soon as it is politically expedient. The application of the stability pact also shows how the EU's rules are used differently with regard to large and small countries. It

is difficult to understand why the governments in, for instance, Denmark, Finland, the Netherlands, Sweden and Austria have yielded to this instead of utilising their right of veto.

The presentation of the changes in the stability pact further undermines respect for the EU. Although it is quite obvious that the pact is being severely weakened, the revisions in the finance ministers' agreement are depicted as a means of "improving" or "strengthening and clarifying" the rules. Some of the wording is downright comical; "the excessive deficit procedure should *remain simple, transparent and equitable*" and "the guiding principle for the application of the procedure is the *prompt* correction of an excessive deficit" (my italics). The reforms entail the exact opposite: the procedure will instead become complicated, unclear and unfair (by expanding the scope for treating different countries in different ways) and excessive deficits need only be corrected slowly. Without claiming other parallels, the EU language often shows considerable similarity to the "newspeak" in George Orwell's 1984.

The changes to the stability pact will lead to a gradual deterioration in government finances in the EU member states. It is easy to envisage a process where poor budgetary discipline in one country will justify lax policy in other countries. This could even affect Sweden, where there is already a tendency for the government to "justify" departures from its budget targets with the claim that things are even worse in other countries.

One has to draw the conclusion that the attempts to secure stable government finances through rules at EU level have largely failed. This requires stronger national frameworks. However, it can hardly be expected that France, Germany and Italy will implement these changes. This provides even greater reason for countries more anxious to maintain fiscal policy discipline to implement such reforms. They could then serve as models for other EU countries.

Stronger national frameworks should contain clear goals both for the budget balance over the economic cycle and for how fiscal policy should be used to reduce cyclical fluctuations. In addition, mechanisms should be established to manage situations where the government does not follow its own guidelines. In the case of Sweden, this could involve a requirement that the government explain its actions to parliament in a well-specified procedure and that public hearings be held with the finance minister, Riksbank governors and other experts.

Budgetary discipline could be further reinforced if parliament appointed an independent council of fiscal policy experts. Their task would be to provide recommendations for suitable fiscal policy on the basis of guidelines established by parliament. Of course, the government would not be obliged to follow these recommendations, but if it chose not to, it would be formally required to justify its actions in special forms. The government could also be obliged to base its budget calculations on the council's assessments.

A common objection is that this type of reform curtails democracy. That is incorrect. On the contrary, democracy would be reinforced if the voters were given a better basis for assessing the policy pursued. The revisions to the stability pact indicate politicians' inability to withstand short-term temptations if they do not limit their own freedom of action. The EU finance ministers appear to have realised this, as they in their agreement express the hope that national institutions will "play a more prominent role in budgetary surveillance to strengthen national ownership" via public opinion. It sounds like a cry for help.

Lars Calmfors