

COMMENT & ANALYSIS: A better plan for loosening the pact

By Lars Calmfors and Giancarlo Corsetti
Financial Times; Nov 26, 2002

The European Union's stability pact has been much derided. To restore some credibility, the European Commission will tomorrow present its reform proposals. Yet preserving the spirit of the pact will require more fundamental changes than a new interpretation.

The basic problem is how to combine long-run fiscal discipline with short-run flexibility. The stability pact is mainly geared towards the first aim: to create a counterweight to the risk of fiscal profligacy. There has always been a fear that the incentives for fiscal responsibility would weaken once monetary union was created. Recent developments confirm these fears. At the same time, there is a case for refining the stability pact to facilitate counter-cyclical stabilisation.

Any modification of the EU fiscal policy framework involves a trade-off. On one hand, reforms must not be seen as giving in to claims from member states with current difficulties, since this would ruin the future credibility of any rules. On the other hand, if the current framework is viewed as too rigid it will lose its legitimacy.

One improvement would be to formulate the "medium-term" objective for a government budget of "close to balance or in surplus" explicitly in cyclically adjusted terms, as proposed by the European Commission. Cyclical variations around a balanced budget should not be considered a problem.

What should be avoided is a relaxation of the budget target over the cycle, given the future strain on government budgets of ageing populations. Reductions in government debt, and thus in interest payments, are one way of mitigating this problem. So this is not the time to loosen budgetary requirements by introducing a "golden rule", according to which governments can borrow for investment.

A crucial issue concerns the ceiling of 3 per cent of gross domestic product for the budget deficit, breaches of which may trigger fines. The threat of such sanctions forms the backbone of the pact. It has been suggested that the deficit ceiling should be reformulated in terms of the cyclically adjusted budget balance. However, there exists no generally accepted method of adjusting the budget balance for cyclical factors. One cannot therefore impose sanctions on the basis of such estimates.

There is, however, a strong case for taking government debt into account when judging whether a member state has an excessive deficit. Indeed, a main benefit of low debt should be to increase the room for manoeuvre in stabilisation policy in recessions. This is an argument for allowing low-debt countries to run larger deficits in downturns than high-debt countries.

Our proposal is to allow countries with a lower debt-to-GDP ratio than, say, 55 per cent to run larger deficits than 3 per cent of GDP in recessions. The deficit limit could then be raised in steps as the debt ratio was lowered. Such a "ladder" of deficit ceilings would enhance the incentives for fiscal discipline, as governments would

enjoy the visible benefit of moving up a rung after reducing their debt.

For reasons of credibility it is important that any changes in the maximum deficit do not accommodate the current budgetary problems of Germany, France and Portugal. Our proposed 55 per cent limit would not do this, as these countries will all have debt ratios close to 60 per cent next year.

Another fundamental problem concerns enforcement of the EU fiscal rules. EU finance ministers have a strong incentive to be forgiving towards colleagues with deficit problems, as this reduces the risk of being castigated in similar situations. The root of the problem is that the final say in the excessive deficit procedure is made by the very politicians responsible for these situations.

There is a strong case for depoliticising the enforcement process, perhaps even transferring the ultimate decisions on fines from the political level of the council of ministers to the judicial level of the European Court of Justice.

Our proposals do not cover the current budgetary problems in some member states. But it would be a mistake to change the long-term rules to solve a short-term problem. There is no "quick fix", as the present situation was caused by insufficient fiscal retrenchment in the earlier boom. With a drawn-out recession, one cannot rule out a development where some member states will have to pay fines. Such an outcome might not be all bad, as the credibility of the sanction procedures would then no longer be in doubt.

The writers are professors of economics at Stockholm University and the University of Rome and members of the EEAG Group at CESifo in Munich