

# **Europe's Fiscal Rules Need a Serious Overhaul**

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## **Introduction**

Europe's monetary union is a bold and original undertaking. While most of the key issues that had to be faced have found satisfactory responses, not everything can be right the first time. The Stability and Growth Pact (SGP) stands out as the most serious deficiency. The flaws of the SGP have been described soon after its adoption<sup>1</sup> and it has not taken very long until they have been revealed. By late 2002, the question is not whether the SGP needs to be improved upon, but how.

The failure of the SGP to live up to the ambitions of its inventors reveals the dangers inherent in across-the-board rules that do not provide for enough flexibility in the face of unexpected events. This failure saps the very discipline that the SGP was designed to deliver. It acts as a deterrent to further countries joining the euro area. It feeds the still-prevalent view outside of Europe that monetary union is an idea that has been implemented ahead of its time.

This note analyses the main flaws of the SGP. It considers the need for fiscal policy to be allowed to play a macroeconomic stabilization rule since, in the absence of "federal" transfers, the only mean left to national governments to deal with cyclical downturns is to borrow. Finally, it considers the current debate on whether and how to reform the SGP.

## **Flaws of the Stability and Growth Pact**

After two decades of profligacy, the need for fiscal discipline is now unquestioned. The drafters of the Maastricht Treaty were keenly aware of the risks that the lack of discipline in some countries could wreak upon the monetary union. They mostly feared that the European Central Bank could be forced to renege on its legal obligation to deliver price stability. They were also concerned with possible free-riding by some countries which would attempt to coax support from the other members. To that effect, the drafters of the treaty carefully protected the ECB from outside interference (art. 101, 108), and included a no-bailout clause (art. 103). While these provisions guarantee that the costs of fiscal indiscipline will remain ultimately circumscribed to the delinquent country, the drafters also wished to prevent crisis

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<sup>1</sup> Eichengreen and Wyplosz (1998).

situations. The principle of an excessive deficit procedure (art. 104) laid down the principle that fiscal discipline is a going collective concern. The procedure calls for a limit on annual deficits and envisions a graduated process of peer pressure that goes from mutual surveillance to warnings, to specific mandatory recommendations and, finally to sanctions. The SGP codifies the excessive deficit procedure.<sup>2</sup>

The SGP represents but one approach to fiscal discipline. Its key characteristics are: a focus on annual budget deficits, the adoption of a single quantitative and asymmetric rule, a highly restricted escape clause, and implausible sanctions imposed from outside. Each of these elements is problematic.

- Fiscal discipline is an elusive concept. Formally, it requires that the government respects its budget constraint, but this constraint is intertemporal and relies mostly on future actions which are neither predictable nor amenable to binding commitments. Focusing, as the SGP does, on annual budget balances goes a long way towards eliminating intertemporal burden-shifting, i.e. it imposes that much of the adjustment to contingencies be bottled up in the years when they occur. This imparts a good deal of rigidity to the SGP.
- Once the choice has been made that fiscal deficits ought to be constrained, the next question is how? The SGP's response is to establish a quantitative limit on the size of allowed deficits. This limit, 3% of GDP, is largely arbitrary. It is based on some back-of-the-envelope calculation of the link between the 60% debt limit<sup>3</sup> and feasible budget balances and on the German Golden Rule. This rule considers that it is all right that public investments – presumed to average 3% of GDP – be financed through borrowing. Unfortunately, the border between public spending and investment is fuzzy, and there is no guarantee that public investments generate a rate of return that matches the cost of borrowing.
- In addition, a single quantitative limit for each and every country flies in the face of common sense. Some countries are saddled with huge debts, others can afford some slippage. Furthermore, if wisely designed, public investment is likely to be more productive in some countries – this will be the case in many of the accessing countries – than in others.
- Rules matter little unless they are backed by an enforcement mechanism. The SGP's strategy is to privately and publicly embarrass delinquent governments and possibly impose a fine. This may be acceptable if the governments are prone to abuse their public opinions into believing that fiscal indiscipline is acceptable. If, on the other side, the governments and their public opinions broadly support fiscal discipline, external sanctions are bound to conflict with political legitimacy and to generate deep “anti-Brussels” resentment. Since the decision on sanctions lies in the hands of the highly political Council, there is a serious risk that sanctions will be

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<sup>2</sup> In what follows, I refer to the combination of the excessive deficit procedure and of the SGP as the SGP.

<sup>3</sup> The 60% public debt limit is also included in the SGP. In 2002, the euro area debt amounts to 71.4% of GDP, four countries have debts above 60% and three more have debts above 57%. Pragmatically, this limit has been ignored so far.

perceived as politically motivated. Fines, in particular, elicit bad memories of war reparations and are unlikely to be imposed. If this assessment is correct, much of the SGP's alleged rigour evaporates.

### **Stabilisation Properties of the Stability and Growth Pact**

As the last remaining national macroeconomic stabilization instrument, fiscal policy must remain an important tool in the hands of governments. The asymmetry of the SGP implies that fiscal policy may have to become pro-cyclical in downturns while there is no incentive to make it counter-cyclical in upswings. This flaw has been partly recognized. In order for the automatic stabilizers to be allowed to operate, the SGP includes a non-binding presumption that budgets will be kept close to balance or in surplus in normal conditions.

Rough estimates suggest that, on average, the automatic stabilizers lead to a deterioration of the budget of some 0.5% of GDP for any 1% decline in the output gap. Thus, in principle, starting from a position of balance, the automatic stabilizers will keep deficits below 3% for a slowdown as deep as 6%. The problem is that, on average, a 1% increase in the budget deficit (or reduction of the surplus) boosts GDP by about 0.5%. The automatic stabilizers thus cushion the slowdown only by one quarter of the initial shock. The automatic stabilizers work, but they are weak. Clearly, most governments will want more stabilization, hence the need for enough additional room for some discretionary action.

Discretionary fiscal policy is frowned upon by the proponents of the SGP for two main reasons. First, they argue that because of long lags (recognition, decision and implementation), discretionary fiscal policy is usually pro-cyclical, i.e. that its effects come too late, when the cycle has already moved to its next stage. Second, they claim that discretion is the open door to indiscipline. These arguments are dubious. The evidence on the cyclical nature of fiscal policy in Europe is muddled. In general, fiscal policy is found to be mildly counter-cyclical, with the notable exception of Germany where procyclicality seems to have prevailed over the last decades.<sup>4</sup> Furthermore, if lags are the culprit, steps ought to be taken rather than giving up on the last remaining macroeconomic stabilization instrument.

As to the view that discretion ought to be eliminated to uphold discipline, it presumes that rules always dominate discretion, a conclusion contradicted by both theory and evidence. Theory establishes that, even for moderately undisciplined governments, it is never desirable to discard discretion. Experience shows that, when adverse shocks hit, binding rules lead to disastrous situations (the Great Depression), or are ignored (many IMF programmes), or both (Argentina).

The short experience with the SGP buttresses these conclusions. A number of countries have indeed moved to positions of budget balance or surplus, others did not. The failures to take advantage of the relatively prosperous early years can be seen as a proof of indiscipline. Alternatively, they can be seen as a confirmation of the

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<sup>4</sup> See Buti et al (1997), Melitz (2001), Wyplosz (2001).

asymmetric nature of the SGP, which provides little incentive to adopt tight policies when the economy grows satisfactorily.

It was always understood that the early years would be the most challenging ones since, by 1999, budgets were in sizeable deficits in most countries. The hope was that favourable economic conditions would lay the ground for deficit cutting in time for the next slowdown. This was not to happen. The downturn came unexpectedly soon and the larger countries did not act as aggressively as they should have.

Many governments face large demands for higher spending and/or reduced tax pressure, all of which have sound justifications and are democratically supported. The fact that the SGP is monitored “from outside” greatly undercuts its democratic legitimacy. While small countries seem more sensitive to peer pressure, public opinions in large countries look down upon “Brussels”. Perceived national spending or tax priorities take precedence, a fact that can be deplored but that should not come as a surprise and has to be fully factored in.

### **Links with Fiscal Federalism**

Part of the difficulty with the SGP is that Europe is far from operating a federal redistributive system. When a country undergoes a recession, it is optimal to borrow to repay in better times. Many households and firms are credit-rationed and therefore have to rely on state transfers to smooth incomes and employment. The state can either borrow or receive temporary support akin to an insurance mechanism. In federal systems, a variety of procedures provide some degree of cushioning through automatic and discretionary transfers. The absence of cyclical transfers in the EU implies that states can only borrow.

The US example is interesting in this respect. Most states operate under very restrictive budgetary rules, typically capping deficits or outlawing them altogether. On the other side, the federal budget allows for automatic transfers which typically offset about 15-20% of revenue shortfalls. In addition, people move easily across states. Mobility in Europe is limited even within countries, but cross-border mobility is hampered not only by obvious language barriers, but also by institutional features in the area of pensions and health insurance.

The SGP is not as strict as the US state borrowing restrictions, but its political and economic acceptability would be greatly enhanced by some features of federal federalism as well as enhanced mobility (even though the latter seems to be perceived as painful and should therefore not be seen as an important adjustment channel). In the mean time, the SGP is far too rigid,

### **The Way Forward**

Following the realization that the SGP is being proven difficult to implement and enforce, the current debate can be summarized to three main views.

- The strict rule-enforcers. The first view is that those countries which are failing to meet their commitments have been undisciplined. The SGP is achieving its aims and should be fully applied. This view is held in the smaller countries that are running surpluses and by the ECB. It is predicated on the hope that, eventually, all countries will run budgets close to balance or in surplus and that this will leave sufficient room for the working of the automatic stabilizers. The claim is that any relaxation of the pact will be a sign that discipline has been abandoned, with severe financial market implications, notwithstanding the fact that market participants in fact mostly fear a deepening of the slowdown.
  
- The marginal reformers. The second view, well represented by the Commission, is that the SGP needs to be adapted, especially in its early years. It recognizes the need for the automatic stabilizers to be allowed to operate somewhat, while calling for a procyclical discretionary action (i.e. reducing the structural deficit). It aims at eliminating some of the most glaring flaws of the SGP with minimal formal changes. Proposals to shift to structurally-adjusted measures and/or to give more prominence to the golden rule raise as many questions as they solve. As noted above, both changes stand to open up Pandora boxes that are bound to greatly complicate matters in the future.
  
- The radical reformers. The last view, so far confined to academic researchers, considers that the SGP suffers from too many flaws for a light patch up. A brief summary of the proposal advanced by Eichengreen et al. (1999) and Wyplosz (2001) runs as follows.
  - Fiscal discipline ought to be defined in term of the public debt (including contingent liabilities currently conspicuously overlooked) over the duration of a business cycle.<sup>5</sup>
  
  - Most European countries currently need to lower their debt to GDP ratios, but debt targets ought to recognize the different starting positions of EU members.
  
  - The definition of the objectives cannot be left to arbitrary rules (e.g. the Maastricht 60% limit). These objectives, and the horizon for achieving them, must be agreed upon by each country – with full involvement of national governments and parliaments – and its partners. Countries must own their commitments.
  
  - Enforcement must be delegated to national watchdog institutions. These institutions must be based on the same set of principles across the EU.
    - They ought to have the sole legal power to set the annual deficits, with no say whatsoever on the size and composition of spending and taxes.
    - Much like with central banks, the task ought to be delegated to independent experts who are given a clear long term mandate (a debt target) with full short-term discretion.<sup>6</sup>
    - They must be accountable to their respective national parliaments, but only for their compliance with the long term mandate.

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<sup>5</sup> This is in line with the British Code for Fiscal Stability.

<sup>6</sup> This would considerably reduce the lags that mar the discretionary use of fiscal policy.

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