An Essay Supplement to Chapter 15

The Commission Issues a New Proposal to Reform the Stability and Growth Pact

The European Commission has recently issue new proposals to breathe life into the moribund Stability and Growth Pact.
(http://europa.eu.int/comm/economy_finance/publications/sgp/2004/comm581_en.pdf)
This proposal is now being discussed by the Council of Finance Ministers (Ecofin). While disagreements remain, it is likely that the proposal will be endorsed in some form in early Spring 2005. The proposal is anticipated in Section 15.4.6.

Appraisal

The Commission's strategy is to claim that the pact is well and alive but to defang it to the point of irrelevance. On the surface, it is a good thing. The pact had to go because it violated elementary economic wisdom. By extending the concept of exceptional circumstances – the object of disagreements in Ecofin – to deal with "country specific circumstances", the Commission's proposal breaks the automaticity that was to be the pact's might. The Commission is right. Putting fiscal policy on automatic pilot makes little economic sense; it also goes against the fundamental democratic principle that budgets are decided by parliaments, not by automatic rules.

The Commission should also be commended for having set aside suggestions aiming to apply the 3% deficit criterion to cyclically-corrected budgets. Not only is the computation of cyclical adjustments subject to so many practical difficulties that almost any number could be churned out, But there is no reason why citizens and their parliaments should have to learn such arcane concepts if they all they want is to understand why they pay taxes.

Finally, the Commission also rightly recognizes that the proper yardstick of fiscal rectitude is not the annual budget balance but whether adequately measured public debts, decline when they are too big.

Comments

The old pact was so rigid that it was inapplicable. The new one is likely to be so flexible that it will never apply. To be sure, Finance Ministers will still be handed out thick reports by the Commission detailing their failings. They will be invited to exercise "peer pressure" on one another. Sinners will promise virtue, and then go back to their capitals only to sin again. Just like the previous one, the revamped pact will reward hypocrisy,. As always, the victims will be the taxpayers. With a few shining exceptions, acknowledged public debts are already high in the Euro zone, but actual public debts are much higher. Retirement and health benefits that baby-boomers will soon claim often add more than 100% of GDP. Governments suffer from a deficit bias: they love to leave big bills to their more or less distant successors. Most of us do not like to bequeath hefty debts to our children. Yet this is precisely what our governments do. Ordinary taxpayers – and their descendants – need to be protected against the deficit bias.

We need to go back to basics and recognize that governments must be prevented from misbehaving. This has nothing to do with the monetary union but, since the pact exists and is unlikely to be repealed, it is best used to prod member countries into adopting procedures that drive public debts to reasonable levels. There is no reason for uniformity. Each country has its own ways of combating crime or choosing leaders.

In the same way, each country can develop its own institutions to prevent the deficit bias. Those who lament that the Stability and Growth Pact failed because the Commission was too weak, miss the elementary point that the Commission should never have been dragged into this business in the first place. It has smartly extricated itself from this trap, but it could have gone one step further and called upon national parliaments to take the deficit bias issue into their own hands, as they are constitutionally bound to do. The pact must become a formal agreement to build national institutions that deliver proper budgetary policies. As guardian of the Treaty, the Commission should propose a template and monitor progress, and, if needed, bring recalcitrant governments to the European Court of Justice.

Questions to be discussed

1. The proposal seeks to adopt country-specific criteria to judge when a deficit is “exceptional”. How would you go about developing such criteria?

2. Some countries (e.g. Netherlands) want the criteria to be tightly specified, others would like them to be left to the Council’s appreciation. Does it matter? Why?

3. The Commission also wishes to pay more attention to the size and evolution of public debts. Does it make sense? Why?