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Reforming the Stability and Growth Pact

Flexible Deficit Rules but Strict Limits on Public Debt

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In its present form, the Stability and Growth Pact runs counter to its intended effect, since it tends to encourage debt especially in slow-growing economies. This is because of a design fault: very few states simultaneously comply with the 3% ceiling for the budget deficit and the 60% limit for the public debt as witnessed by the actual growth rates and debt ratio in the EU. For this reason the recommended policy would be to retain only the "debt ratio" reference value (60% of GDP). Instead of the rigid 3% rate for maximum new borrowing, the proposed alternative rule would take growth and total public debt into account.

On January 17, 2005, the eurozone finance ministers sharpened the excessive deficit procedure against Greece that had been initiated in 2004. The current budget deficit in Greece, at 5% of GDP, is the highest of all euro countries. The Greek economy is also growing fast in nominal terms. The pact, however, does not take the growth rate of an economy into consideration but instead superficially looks at the reported new borrowing. In addition, the Greek debt ratio (public debt as a share of GDP) has been declining for years, and also declined in 2004. In other countries—Germany, France, the Netherlands, and Portugal—it has increased again in recent years.

Is Budget Consolidation Harmful to Growth?

Currently many politicians and experts are arguing for a flexible interpretation of the Stability Pact. This has put them on a collision course with a number of institutions such as the EU Commission, the European Central Bank, the German Council of Economic Experts and the Bundesbank, which insist on strict adherence to the Stability Pact. The argument that strict compliance with the pact in the current downturn would have a pro-cyclical effect and cause still more unemployment would hardly be refutable if the consolidation of national finances led to stagnation or even a decline in GDP. This could happen very quickly if, on the one hand, nominal growth is weak and, on the other, deficits must be significantly reduced. Slowly growing economies, in nominal terms,

which last year included the Netherlands (2.2%), Germany (2.6%), Portugal (3.2%) and France (3.4%), whose budget deficits were at or above the three-percent limit, violate or have difficulty complying with the Stability Pact.

An immediate reduction of new borrowing by one percentage point, under otherwise unchanged conditions, would lead in Germany to a decline in nominal growth of total demand, and hence of the economy, by approximately 2%. Real economic growth, with an inflation rate of at least 1.1%, would be at most a meager 0.9%—too low for a cyclical reduction of unemployment. Similar results would occur for other EU economies.

To what extent is the opposite argument relevant for economic policy, that an increase in the deficit would help the economy recover? Past experience with deficit spending as a means of stimulating the economy is not positive. To be sure, many countries have tried to boost or at least maintain growth by using this method. In the 1980s and early 1990s, countries like Belgium, Greece, Italy, the Netherlands and Portugal pursued relaxed budgetary policies that brought about only moderate growth. France allowed its budget deficits to increase in the early 1990s without being able to prevent a simultaneous drop in economic growth rates. Recently Japan, for decades the model of disciplined budget policies, tried to overcome its growth stagnation with massive deficit-financed economic stimulus programs: the effect is a record debt-to-GDP ratio of currently 161%, but no significant economic recovery.

In light of this experience, the Stability Pact has clearly had a disciplining effect on budget policy in the eurozone. Moreover, despite what its critics say, the pact seems to have had a cyclically neutral effect in recent years. According the EU Commission, the eurozone countries—and also Sweden and Denmark—despite similar budgetary policies have differing GDP gaps (difference between GDP growth and potential growth). These deviating growth results must have been caused by factors other than fiscal policy—perhaps by differences in capital expenditure or in advances in productivity and technology.

How does the interplay between the two key factors—budget deficits and public debt—affect current and total indebtedness? The 3% and 60% rules cannot be convincingly derived from growth or budget theory; these reference values, which were established in 1992, were based on the experience of the 1980s and early 1990s, years in which the growth rates in the EC-12 were in part more than 3% p.a. and new borrowing of up to 3% of GDP was regarded as a suitable method of growing ones way out of debt. To achieve this it was necessary that the debt ratio, that is accumulated debt as a share of GDP, did not increase that much. If new borrowing as a share of GDP approximates the growth rate of GDP, growing one's way out of debt is not possible; the 60% ceiling was meant as an alarm to signal that stronger efforts were necessary.

Moreover, differing rates of debt—which implies different budgetary and cyclical-policy approaches—prevented the creation of an optimal currency area. The consolidation attempts of especially the larger economies have an anticyclical effect in this case and impair the efficiency of the now homogeneous monetary policy. This is an argument for a converging public debt level of the participating countries. The Stability Pact can be an instrument to achieve this.

Higher Indebtedness Despite or Because of the Stability Pact?

Since the application of the debt rule does not restrict growth in itself, the Stability Pact should be retained. Adjustments to the pact should concentrate on eliminating an elementary design fault. And this will not be eliminated by enlarging the scope for deficit spending beyond the 3% limit.

The goal that fathers of the Stability Pact wished to achieve was to establish uniform budget standards for all eurozone coun-

tries. Twelve years after the Maastricht Treaty took effect it is clear however, that the EU economy is much too heterogeneous to function according to the "one-size-fits-all" principle. The obvious weakness of fixed reference values is their uniformity. A uniform valuation of heterogeneous economies will very likely lead to incorrect or politically questionable economic- and budgetary-policy recommendations by the Commission.

An additional weakness is that the Stability Pact does not support debt reduction during a cyclical upswing. According to the Commission, the cyclically adjusted primary balances were strongly negative in the Eurozone between 2000 and 2002, the period of the largest, positive GDP-gaps. At the time, budget-policy incentives were lacking to keep these differences positive and instrumental for debt reduction. The pact, which was designed with sanctions in mind, did not encourage using this opportunity for far-reaching consolidation.

The excessive deficit proceedings launched against Greece strictly follow the letter of the Stability Pact. Because Athens repeatedly reported greater deficit margins than the permissible 3%, the Commission *must* act. At the same time Greece is well on its way to a general reduction of its debt burden. Its accumulated debt is increasing more slowly than nominal GDP, as a result total indebtedness is decreasing. A contributing factor was not least the fiscal relaxation; according to the EU Commission, current Greek growth exceeds potential growth by around one percentage point. The amount of new borrowing should not be objectionable so long as total indebtedness declines. There is no reason for Greece to be sanctioned.

The diametrically opposite case can occur in a country that practices formal fiscal discipline. For example, nominal growth in the Netherlands in the past three years was 2%, on average; new borrowing was nearly 3% of GDP—in keeping with the pact. As a result the debt in the Netherlands has been increasing continuously—in spite of "budget discipline". The same applies to other likewise "disciplined" eurozone member states whose debt ratios are also increasing again after the successful reductions in the 1990s.

Eliminating Design Faults

It is evident that the 3% rule is problematic in terms of fiscal policy and is counterproductive. In the current phase of slow growth in numerous EU countries, the effect of the pact's automatic nature is to encourage debt. In fast growing economies it slows the pace of growth with the unwanted side-effect of delaying a reduction of the national debt.

The 3% rule thus collides with the 60% rule. Complying with the one criterion prevents compliance with the other. In the reform negotiations, the finance ministers should accordingly choose *one of the two reference values*. It seems obvious that the 60% rule should receive preference since it accords with the logic of debt reduction and prevents burdening the budget with debt servicing. Countries that presently have a high national debt—Belgium, Greece, Italy, Germany, Austria and France—should be encouraged to lower their debts to the reference value. Other, less indebted member states should avoid reaching the reference value.

If economies with different debt ratios *and* diverging GDP growth rates converge around a fixed reference value (60% of GDP), the other reference value must be variable—purely algebraically. The calls for a more flexible pact are thus justifiable, though not necessarily the way some European politicians have proposed. What needs to be changed is the rigid 3% rule.

The Commission should continue to place pressure on the countries to run up as little debt as possible. The surveillance by the Commission should not be uniform (3% for all). Instead, for every country two national variables should be considered:

1. the growth rate of GDP,
2. the current debt ratio.

Mathematically the debt ratio is constant if new indebtedness as a share of GDP corresponds to the value of the GDP growth rate multiplied by the debt ratio. Consequently, a national economy grows out of debt if the new borrowing is *smaller* than this value, and the debt increases if the new borrowing is *greater.* In order to avoid a pro-cyclical effect in downturn phases, new borrowing throughout the entire business cycle should be taken into account.

The Commission's economic-policy conclusions should be based on the concrete situation of the individual country:

- Excessive debt procedures should be launched against countries with a national debt above the reference value of 60% only when their new borrowing is *larger than/the same as* the growth rate of GDP multiplied by the corresponding respective debt ratio.
- For countries with a debt at the reference value of 60% (the Netherlands, Portugal) the Commission should insist that new borrowing (as a percentage of GDP) is *smaller than/the same as* the GDP growth rate multiplied by a factor of 0.6.
- The Commission should only warn countries that are below the reference value (Finland, Spain, Luxembourg) when their new borrowing as a percentage of GDP is larger the GDP growth rate and the debt ratio.

Conclusions

The formula proposed here and the surveillance procedures merely modify the instruments of the Stability Pact without impairing its spirit. The abiding goal should be to prevent excessive indebtedness. The monitoring procedure derives from the basic mathematical rule that the interaction of two factors is only reasonable in the form of "function—argument." Consequently, both reference values cannot be fixed; the one (the argument) must be variable if a fixed functional value (debt of 60%) is to be attained. This new flexibility of the Stability Pact would facilitate the monitoring of member states' budget discipline by the EU Commission and the fiscal policies of the EU governments.

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