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Improving the implementation of the Stability and Growth Pact

- Député européen (Verts, France) - Économie - Le pacte de stabilité -

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Preliminary remark: how Ministers overcame the last difficulties to reach to an agreement

One of the key issue for the Eurogroup and the Ecofin to resolve on Sunday was certainly whether or not "a list of relevant factors" should be included in the assessment of a deficit that is slightly above the 3% reference value and, if there was a list, which factors should be on it.

Taking into account the difference of positions between countries in this respect (for instance, France wanted investment in research, aid to poor countries and military expenditure to be excluded from the deficit calculations, while Germany wanted the costs of its 1990 reunification to be excluded), the meeting of the Eurogroup and of the Ecofin managed to reach a compromise, which could satisfy all.

The idea of a list giving details of the "relevant factors" allowing for a flexible interpretation of the Pact was abandoned. Instead, the interpretation of "relevant factors" the Member States can invoke in justification of an excessive deficit higher than but close to 3% of GDP will be based on general and basic principles.

The Commission and the Council will above all take account of the potential growth, implementation of the policies of the Lisbon Agenda, research and development and innovation policies, but also efforts made in times of strong economic growth to improve the quality of public finances and public investment. Attention will also be paid to "international solidarity" and of "European political objectives, notably the unification of Europe if it has a detrimental effect on the growth and fiscal burden of a Member State". Through this formula, German and French requirements are implicitly covered.

Main "features" of the "smarter" Stability and Growth Pact:

What has not changed:

The Council confirms that the Stability and Growth Pact is an essential part of the macroeconomic framework of the Economic and Monetary Union.

The two nominal anchors of the Pact - the 3% of GDP reference value for the deficit ratio and the 60% of GDP reference value for the debt ratio - continue to be the centrepiece of multilateral surveillance.

sanctions maintained in the range of pact instruments;

the Commission is confirmed in its role to initiate excessive debt procedure...

What has changed:

clarification of the criteria which should be considered as allowing a deficit above 3% of GDP;

better take into account specific national characteristics (which comes down to calling into question the damaging "one-size-fits-all approach" which prevailed till now);

extra time is given to Member States to come into line with the reference value, etc.

More generally, the main proposals put forward by the Commission, in its communication of 3 September 2004 on "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact" were maintained.

In brief, the guidelines of the reform are:

- the willingness to enhance the governance and the national ownership of the fiscal framework ;
- to safeguard the sustainability of public finances in the long run (among others by taking into account the impact of population ageing, which will increase pressure of health and pension spending, country specific initial debt level, etc.);
- to promote growth (a clear reference is made to the Lisbon goals, and a room for budgetary manoeuvre is allowed to take into account the needs for public investment);
- to avoid imposing excessive burdens on future generations.

Short analysis (see also note written by Jochen Dekinger on this subject in january 2004)

A good way to evaluate the reform of the Pact is certainly to come back to its main flaws:

1. The Stability and Growth Pact was designed as a framework to prevent inflationary processes at the national level. For this purpose, it obliges national governments to follow the simple rule of a balanced budget or a slight surplus. However, experience showed that "simple rules" don't fit with the complexity of economic and monetary policies.

3. The rigidity of the Pact had much to do with its "one-size-fits-all approach":

- by imposing to ALL countries the observance of the 3% limit, the SGP made no differences between "mature" and "catching-up" countries, was regardless of the rate and variability of growth, of investment needs (such as the need for infrastructures or the population age structure, which greatly vary across countries); , etc.
- till now, the SGP overlooked important parameters in assessing the "soundness of the budgetary position" such as investment expenditures (e.g. education) whose return is spread over long periods (which means that the same should hold true for the costs as well).

4. If the SGP is regarded as a framework that contributes to price stability, it suffers from the weak link between government deficits and inflation. Indeed, as a matter of fact, a negative budgetary position can be caused for instance either by excessive government spending (which can impede on the inflation rate) or a poor growth performance. Arising from that, it makes no sense to sanction countries with weak growth and inflation rates below the ECB's target.

5. If one can argue that the SGP helps to establish fiscal discipline which could be lacking without such a framework, the most dangerous bias of the SGP is certainly the neglect of macroeconomic requirements in fiscal policy. In this respect, one of the major shortcomings of the Pact was certainly its "inconsistency", since it forced EMU countries to conduct procyclical policies in period of economic recession (e.g. Germany was a case in point, since the respect of the "rationale" of the Pact implied to reduce expenditure and to raise taxes when recession was looming). More generally, the rigidity of the Pact during the downturn worsens recession since it could imply the cutting down of crucial expenditures like education, basic research and investment.

As regards to these major shortcomings, the overall result of the reform of the Stability Pact is positive, since the Member States have opened the way to a "flexible interpretation of the Pact" on the one hand, and have taken into account the new economic challenges facing the EU on the other hand: the fear of inflation and a weak euro is no longer on the agenda, as it was the case in the inception of the EMU. Instead, many countries suffer from weak growth and increasing unemployment.

Among the positive elements introduced by the reform of the Pact, one can point out the following ones:

- the willingness to keep the rules-based framework simple, transparent and enforceable (3% of GDP ceilings for annual budget deficits and a ceiling of 60% of GDP for overall debt) is better balanced through greater emphasis on economic developments and on increasing the focus on safeguarding the sustainability of public finances.

- a better framework that leads to "sound budgetary positions" by the respect of the "golden rule of finance", which translates the shifting attention from a mere quantitative target to the quality of public finance. Since public investments can help avoiding future expenses in the future (as is the case with expenses to protect the environment for instance) and increase the potential growth rate of the economy, the golden rule is more compatible with growth than the present SGP setting. More broadly, with this reformed Stability Pact, it will be easier to finance high - quality public investments, such as the ones aiming at the de-coupling of growth from energy consumption, transport and resource use, as well as investments needed to meet the Kyoto targets.
- shifting the focus from deficit to debt addresses both the issue of long term sustainability and of the excessive uniformity of rules. For instance, higher growth and inflation rates in catching-up countries, allow them to run higher deficits without jeopardizing the sustainability of public finances. On the contrary, countries with sound public finances can "afford" to have more stringent rules to cut down its deficit during economic upswings.
- better taking into account of economic circumstances in the implementation of the Excessive deficit procedure. With the proposal that excessive deficits should be sanctioned only in times of economic growth and by giving more time to countries to adjust their budget, the reform of the Pact turns once more its back to its limited and counter-productive "one-size-fits-all approach", which set for all countries the same deadline for the deficit correction, regardless of the different debt level and different cyclical developments between countries. Therefore, if the launch of the deficit excessive procedure will still occur and rapid correction would be expected, the appropriate pace would be defined according to relevant economic conditions and to debt levels and will henceforth differ between Member States.

In conclusion, by allowing a flexible interpretation of the Pact, this one could turn into a better mechanism to foster a more qualitative European economic growth and will definitely be a better tool to ensure economic policy coordination than previously (at least, by reconnecting the GSP to the global macroeconomic framework, economic policy coordination should not be limited to "coordinate" nominal budgetary discipline between countries). With this new Pact, it will be easier to reach the goals set by the Lisbon Strategy. However, one should bear in mind that the reform of the Stability and Growth Pact is not enough to face the issue of growth or employment for instance.

Indeed, if the functioning of the Stability and Growth Pact till nowadays stands among the reasons why the employment policy of the EU has so far been disconnected from its macroeconomic framework, it's certainly not the only one. In this respect, it needs to be recalled that among others, the monetary policy led by the ECB was not helpful in fostering growth recovery in the euro area. If it can be explained by the statutory mandate of the EBC, which is precisely to maintain price stability, the bank did not seem able to meet the challenge posed on one side by its new capacity to influence global economic variables such as the exchange rate, and on the other by the constraints on fiscal policy in the EMU that leave monetary policy as the only union-wide tool to sustain growth and income.

In short, in order to "reap the benefits" of the reform of the Pact as a means to achieve the goals set by the Lisbon strategy (and more broadly, the goal of "sustainable development"), it needs to be interlinked with other issues, among which the monetary policy led by the ECB and the financial perspectives.