Franz-Christoph Zeitler: What remains of the Stability and Growth Pact?

Speech by Professor Franz-Christoph Zeitler, Member of the Executive Board of the Deutsche Bundesbank, at the Salzburg Seminar, Salzburg, 26 August 2005.

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1 A glance at the fiscal policy reality in the euro area

Almost half of the countries in the euro area have either exceeded the 3% deficit ceiling specified by the Treaty and the Stability and Growth Pact last year or are in danger of exceeding the threshold in 2005. Six of the ten economies which joined the EU last year have deficits of 3% or more.[1]

Moreover, in a number of the countries, one-off fiscal measures are disguising the true extent of the structural budget problems.

At present, procedural steps under Article 104 of the EC Treaty (excessive deficit procedure) have been instigated against six of the 12 euro-area countries. And six of the ten new ember states are involved in ongoing procedures under Art. 104.

The development of the debt ratios tells a similar story. In seven euro-area countries the debt ratio overshot the 60% reference value in 2004. In three of these countries, Germany, France and Portugal, there has actually been a sharp increase in the debt ratio since 2000.

In Germany, for example, the government deficit exceeded the Maastricht limit in every year since 2002 and even in 2005 the deficit will not be brought back under the 3%-theshold. The consolidated gross debt ratio in Germany increased by more than 5 percentage points since 2000. With approximately 65% in 2004 it is well above the 60%-limit. The high debt is effectively restricting the room for fiscal policy. For 1€ outstanding debt in 2004 nearly 5 cent had to be spent on interest expenses. With 1.4 trillion debt outstanding, in 2004 over 66 billion € had to be paid for interest.

Given the progress that was made in consolidation in the second half of the 1990s, these developments are sobering. The economic downturn which began in 2000 has undoubtedly left its mark on government deficits. However, a glance at the cyclically adjusted figures shows (even bearing in mind the uncertainty in these calculations) that the deterioration of public finances cannot be explained by unfavourable real economic data alone; especially as the interest rate convergence and the period of low interest rates following the launch of European monetary union have significantly reduced the interest burden on general government.

Overall, the cyclically adjusted deficit in the euro area rose from 1.6% in 1999 to 2.4% in 2004. During the same period, the unadjusted primary surplus went down from 2.9% to 0.6%.[2]

This "consolidation inertia" is mirrored at the legislative level by the radical changes made to the Stability and Growth Pact. The term "pact" reflects the political consensus which underlay its creation. In the legal sense, it is not in fact a "pact", meaning an agreement under international public law, but rather two Council regulations[3], in other words, secondary European law. This is reinforced by the European Council Resolution of 17. June 1997.[4] The "mother of all rules" is still the primary law under Article 104 of the EC Treaty and Protocol No 11 on the excessive deficit procedure.

The changes to the Stability and Growth Pact were agreed, after a lengthy debate, by the ECOFIN Council on 20 March 2005 and by the Heads of State or Government at its spring meeting only a few

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1 The information on the budgetary figures (including the cyclically adjusted values) is based on European Commission figures on government data from spring 2005. .

2 The primary balance is defined as the government deficit/surplus excluding interest expenditure.

3 Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ C209, 2 August 1997, p 1 and p 6.

4 OJ C236, 2 August 1997, p 1; in its judgement of 13 July 2004 (C-27/04), the ECJ also mentions the Council Resolution in connection with the methodology of the deficit procedure (71 et seq. of the grounds) as having "defined more precisely and strengthened" the Stability and Growth Pact, without deriving any further specific legal consequences from this.

days later.[5]The Council adopted the relevant changes to Regulations 1466/97 and 1467/97 on 27 June 2005.[6]

As far as the <u>results</u> are concerned, I share the opinion held by most neutral observers: namely, that overall the fiscal rules have been significantly weakened. By contrast, the challenges facing a stability-oriented fiscal policy in terms of public acceptance have grown considerably. The less stringent the rules, the more convincing sound fiscal policy needs to be in daily life. This is because the changes have made the pact less transparent. They have increased the discretion of the national institutions and those in Brussels and they have opened the door to backsliding in the form of generally laxer budget policies.

Even the "old" pact was weakened by the restricted sanctions mechanism <u>arising from primary law.</u> This is often portrayed as a case of "sinners sitting in judgement on fellow sinners". The individual stages of the procedure are initiated by the Commission. The ultimate decision-making power lies, however, with the ECOFIN Council.[7] The reform has not changed this. It would have been better to stick to the criteria and procedures of the old pact, while at the same reversing the "burden of action" – as provided for in the first drafts of the Constitutional Treaty. The ECOFIN Council would then make a decision based on a Commission "proposal" rather than a Commission recommendation as is currently the case. This change, which at first sight appears minor, would have had the significant, material consequence of obliging the Council to reach a unanimous decision if it wished to deviate from the Commission's proposal.[8]

To a certain degree, problems with the political <u>assessment</u> of the deficit data had been anticipated from the outset. Practice has, however, brought to light an additional, unexpected problem concerning the <u>reliability</u> of the data themselves. Here, the Commission relied on the budget and debt figures produced by the national agencies. Great waves were caused by Greece, whose fulfilment of the conditions for accession to monetary union (from 2001) was confirmed on the basis of data which later had to be considerably revised by a different government.[9] It remains to be seen whether cases such as this can be prevented by the planned tightening of the statistical reporting requirements and the possibility of audit inspections by Commission staff of the countries' reporting agencies.[10]

Ernst-Wolfgang Böckenförde, a renowned expert on constitutional law, coined the oft-quoted phrase that the modern, democratic free state, which is governed by the rule of law, lives by preconditions which it is unable to guarantee. A rule-based fiscal policy also survives on preconditions which are neither intrinsic to it nor can be guaranteed by it. First and foremost is the understanding and the willingness to accept the rules in force. And not simply out of respect for the "pacta sunt servanda" – or sanctity of pact – principle, but primarily because the underlying <u>economic rationale</u> is regarded as

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5 Report entitled "Improving the implementation of the Stability and Growth Pact", Annex II to the European Council's conclusions of 22/23 March (7619/05).

6 Council Regulation (EC) No 1055/2005 of 27 July 2005 amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 174, 7 July 2005, p 1; Council Regulation (EC) No 1056/2005 of 27 June 2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 174, 7 July 2005, p 5.

7 Even the member state in question is allowed to take part in the Council vote deciding whether an excessive deficit exists. Only in the further stages of the procedure laid down in Article 104 paragraphs 7 to 9, 11 and 12 of the EC Treaty is the representative of the member state in question not eligible to vote. Pursuant to Articles III-184 paragraph 6 page 4 of the Treaty establishing a Constitution for Europe, by contrast, the vote of the representative of the member state in question would no longer be taken into account when deciding whether an excessive deficit exists.

8 Article 250 (1) of the EC Treaty. Article III-184 (6) p 1 of the Treaty establishing a constitution for Europe provides merely that the Commission has the right to make a proposal for the decision regarding an excessive deficit.

9 According to the ECB Convergence Report, in the reference year 1999, Greece's general government deficit was 1.6%. The deficit in 1999 has been revised upwards to 3.4%, thereby exceeding the 3%-limit. The deficit figures originally reported by the Greek government for 2001-2003 were between 1.4% and 1.7%; these figures were corrected in March 2005 to between 3.6% (2001) and 5.2 % (2003). Moreover, the figures for 2001 and 2003 have not been validated by Eurostat, so it might be assumed that the final deficit figures for these years are still higher than the current reported numbers. For more information on the revision of the Greek deficit figures and govermnet statistics, see the "Report by Eurostat on the revision of the Greek government deficit and debt figures (1997-2003)"SEC(2004) 1539 of 22 November 2004.

10 The Commission has presented a proposal for a Council Regulation amending Regulation (EC) No 3605/93 as regards the quality of statistical data in the context of the excessive deficit procedure COM(2005) 71 final). In its Opinion of 4 May 2005, OJ C 116/11 of 18 May 2005, the ECB welcomed the core objective of the proposed regulation to strengthen the legal framework for compiling relevant budget data.

common sense for any fiscal policy aimed at fostering growth. The economic and legal sides of the pact do not conflict with each other – as is often claimed[11] – but are mutually dependent. This is suggested by the very word "economy (Greek: oikonomia)", which literally means "rules for managing a household". Therefore, I shall now describe in brief the main reasons behind the conclusion of the Stability and Growth Pact prior to the start of European monetary union. These are also the main reasons for and objectives of a rule-based fiscal policy for the euro area.

2 Reasons for and objectives of a rule-based fiscal policy

When the originally planned dual concept of political and monetary union was relinquished in the run-up to EMU, it became clear that European monetary union would have to live with an asymmetry in the management of the two key macroeconomic areas, monetary and fiscal policy. A supranational monetary policy has to coexist with fiscal policies, which essentially[12] remain at national responsibility.

This is by no means an absolute impediment to the successful functioning of monetary union and may even have certain operational advantages, for example, concerning competition between tax systems, social security systems and education systems. However, it also entails economic risks. Thus historical analyses have shown that the monetary unions of the 19th century failed largely as a result of mismatching fiscal policies.[13]

Consequently, Article 104 of the Maastricht Treaty, as well as the Stability Pact adopted by the ECOFIN Council in Dublin in December 1996 largely at the urging of the then German minister of finance, Dr Waigel, attempt to combine the advantages of a fiscal policy which, in operational terms, remains a national responsibility with the necessity of a set of common rules. There are four main reasons for this.

First: to avoid a conflict between fiscal and monetary policy.

At times of high government debt and higher interest rates – which cannot be ruled out especially given the current historically low interest rates – there is a greater risk that attempts will be made to accommodate the nominal debt burden by pressuring the central bank into pursuing a laxer monetary policy, ie forcing it to forgo or postpone interest rate increases needed to ensure monetary stability. A credible monetary policy and the institutional independence of the ECB and the national central banks laid down in Article 108 of the EC Treaty undoubtedly provide a strong counterweight to such pressure. However, the Stability Pact was not aimed at combating an existing conflict between fiscal and monetary policy but rather – based on the wisdom of past political experience – was designed to prevent such a conflict from arising in the first place.

Second: to avoid conflicts within monetary union.

Before the start of monetary union, market forces were able to exercise a disciplinary effect on fiscal policy stances perceived to be unsound through corresponding exchange rate and interest rate responses. Although the market reactions often came relatively late and then overshot the mark, fiscal policy makers always had to reckon with sanctions of this kind from the market.

In a monetary union, public sector borrowers can, for a time, hide some of the economic disadvantages resulting from an unsound fiscal policy under the blanket of monetary union or lessen the impact of market responses to such a policy by distributing them across the monetary union. Economists call this a fiscal externality, others talk of freeriding or moral hazard: countries with a sound fiscal policy that had to impose painful cutbacks on their citizens are forced to carry the can for less disciplined member states.

In a nutshell: In a broad and liquid financial market, higher deficits of a specific country may have less impact on the interest rates : a stone causes greater waves when thrown into a garden pond than it does when thrown into a lake.

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[11] For example, see Hans Eichel (2003) "*Der Pakt ist kein Strafgesetzbuch*"; Frankfuter Allgemeine Zeitung, 15 November 2003, 12.

[12] The EU budget is of secondary importance in this context.

[13] For example, see: Therresia Theurl (1999), *Erfolgs- und Misserfolgsfaktoren von Währungsunionen: Historische Erfahrungen*, Zeitschrift für bayerische Sparkassengeschichte, 13, 129-156 .

Those of us who regard the long-term internal cohesion of monetary union and the avoidance of centrifugal forces as a matter of primary importance must therefore vehemently urge the member states to observe the fiscal policy rules.[14]

Third: the interrelationship between sound fiscal policy and growth.

It is often maintained that government deficits – regardless of the initial debt level concerned – are always conducive to growth. However, a glance at the facts shows that low government debt has a positive correlation to growth because of the resultant boost in confidence, lower tax burden, greater involvement and efficiency of the private sector.[15]

Within European monetary union, this has been demonstrated in recent years by the example of countries such as Spain, Finland, Ireland and also Belgium, which has cut its high debt level (of more than 140% before the launch of monetary union) to approximately 96% (in 2004) and in recent years has recorded considerably higher growth rates than Germany, for example. Canada provides an interesting example outside the euro area. For the past seven years it has achieved budgetary surpluses and its growth rate has never fallen significantly below 2%.

Leaving aside the debate about the so-called non-Keynesian effects of a fiscal policy aimed at reducing deficits – which, by the way, also proved effective in Germany in the years following 1982 despite all the gloomy predictions made at the time that the country "would save itself to death" – it is widely accepted that a high debt level impairs the stabilising role of fiscal policy even in respect of short-term growth stimuli. This is because an expansionary fiscal policy has less impact in an environment of high deficit and debt levels than in an economy with structurally sound public finances. The marginal utility of short-term fiscal policy stimuli decreases as debt increases owing to economic agents' expectations of a later correction of the debt level and hence of the future burdens associated with all debt.

Fourth: the need to tackle growing implicit government debt, in other words, the demographic burden

resulting from ageing populations in western Europe.

As studies by the Bundesbank and the German Council of Economic Experts have clearly shown[16], in addition to the explicit government debt on which the public debate is focused, the impact of implicit promises of future state benefits from the social security systems should not be overlooked. For many member states, Germany in particular, these constitute a real problem in terms of the sustainability of public debt.[17] The Bundesbank estimates that they have raised the long-term consolidation requirement to over 3½% of GDP.

Thus, a rule-based fiscal policy is also necessary out of fairness to future generations. In the language of public choice economists, the Stability Pact constitutes an insurance policy against the temptation for politicians to purchase votes today through high borrowing at the cost of future generations.

3 Criteria for a viable fiscal framework on the basis of the former Stability Pact of 1997

In order to place those fiscal and economic objectives of the Stability Pact which I mentioned earlier on a viable operational footing, the fiscal framework must fulfil the following criteria.[18]

Simplicity, transparency and consistency – this is particularly important if the framework is to appear

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14 For a debate along the lines of this argument see Harald Uhlig (2002), *One money, but many fiscal policies in Europe: what are the consequences?* Tilburg University. Center for Economic Research Discussion paper 2002-31.

15 The fact that sound public finances have a positive effect on an economy's long-term growth is well documented in empirical growth analyses. For example, see D Romero de Avila and R Strauch (2003), *Public Finances and Long-Term Growth in Europe – Evidence from a Panel Data Analysis*, ECB Working Paper 246; S Fölster and M Henrekson (1999), *Growth and the Public Sector: a Critique of the Critics*, European Journal of Political Economy, 15, 337-358; S Fölster and M Henrekson (2001), *Growth Effects of Government Expenditure and Taxation in Rich Countries*, European Economic Review, 45, 1501-1520.

16 See Deutsche Bundesbank (2004), *Demographic burdens on growth and wealth*, Monthly Report, December.

17 For the base year 2002, the German Council of Economic Experts estimates the present value of the implicit debt in the range of 270% of GDP compared with explicitly recorded debt levels of roughly 60%.

18 See Kopits and Symanski (1998), *Fiscal Policy Rules*, IMF occasional paper 162.

credible to the general public and in terms of its efficiency when applied by the member states.

Fixed incentives and sanctions system in the event that rules are breached. Rules without a fixed incentives and sanctions system will not be taken seriously. This applies equally to private life as it does to the actions of governments and states.

Ensuring fulfilment of the medium and long-term objective of a balanced budget while providing short-term scope for "automatic stabilisers" ("flexibility criterion"). As you know, automatic stabilisers is a modern term for deficits resulting from cyclical tax revenue shortfalls and additional labour-market related expenditure.

Despite the undeniable political compromise which characterised even the earlier pact – especially concerning the absence of an automatic triggering, whether based on legal provisions or other mechanisms, of the system of sanctions – the former rules largely fulfilled these requirements.

The key underlying principle for the medium term is clear: a budget which is balanced or in surplus. This provides scope for deficits in the short term to overcome cyclical shocks. A clear legal and optical "anchor" is provided by the 3% deficit ceiling accompanied by a fairly precise definition of exceptions for natural disasters and severe economic downturns (2% decline in GDP on an annual basis or a decline of at least 0.75% or more at the Council's discretion pursuant to the Council Resolution of 17 June 1997).

In particular the 3% ceiling has often been described as "arbitrary" or even "stupid" (Prodi). Of course, by its very nature a rule must be clearly defined and the result of an expression of political will. This applies to the duties of citizens – for example, the blood alcohol limit for drivers, the deadlines for submitting tax returns or the limits for work-related tax-deductible expenses – just as much as it does to the actions of public-sector bodies.

But the 3% ceiling was never "arbitrary". Owing to the difficulties involved in effectively defining the actual objective of a cyclically-adjusted balanced budget, the nominal balance was deliberately chosen and, at the time of the pact negotiations in 1996, the 3% ceiling defined for the deficit was regarded as very generous. Furthermore, the 3% ceiling is closely linked to the 60% ceiling for government debt. For example, assuming nominal growth[19] of 5%, over time a 3% deficit would tend to lead to a debt level of 60%. Given the more humble growth rates to which we have grown accustomed in recent years, a much lower deficit ceiling would be more appropriate.

The problems and weaknesses of the old pact were not due to it being too rigid. On the contrary, they lay in the weakness of the political decision-making process for the incentives and sanctions system and in a preventive effect which was too modest. Consequently, as the European Commission[20] also found – the governments' medium-term stability programmes systematically overstated growth and hence budgetary developments, in other words, opportunities were overestimated and risks underestimated.

4 Changes made to the Stability and Growth Pact in 2005

The changes were agreed on 23 March 2005 following a protracted political debate, coordination between the German and French governments and the active participation of the Luxembourg President of the EU Council Jean-Claude Juncker. They concern both the fundamental, "preventive" arm of the Stability Pact as defined in Council Regulation 1466/97 on the surveillance of budgetary positions, as well as the "corrective" arm laid down in Council Regulation 1467/97 on speeding up and clarifying the excessive deficit procedure.

(1) In the "preventive" arm of the pact, the medium-term budgetary objective which previously applied to all member states (balanced budget or surplus) has been modified by country-specific considerations. Under Article 2a of the new Regulation, the medium-term budgetary objectives are to be set – taking into account the debt level and potential growth rates of the member states concerned – within a range of up to -1% of GDP.[21]

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[19] Based on inflation of up to 2% in line with ECB's stability objective, 3% real growth is assumed overall.

[20] European Commission (2005), Public Finances in EMU

[21] Targets are set only for euro countries as well as for ERM II participating countries.

Moreover, the member states are allowed scope to deviate from the "adjustment path" (Article 5 (1) amended), ie the path towards achieving this country-specific objective, if they are implementing structural reforms, in particular the transition to a partially funded public pension system.

In the Regulation itself,[22] the reason given for the change-over to country-specific budgetary targets is the "economic and budgetary heterogeneity" of the member states. This clearly conflicts with the underlying concept of European monetary union, the key component of which is a single monetary policy based on the idea of "one size fits all".[23]

The proposition that structural reforms inevitably place a short-term burden on the budgetary position does not appear to be fully supported by the empirical evidence. In fact, certain essential reforms, in particular of pension systems but also of labour or goods markets, as well as some tax reforms (with no impact on tax revenue), actually have a positive effect on the budget.

(2) The changes to the "corrective arm", ie Council Regulation 1467/97, go even further. Pursuant to Article 2 (2) et seq., member states are now permitted to exceed the 3% ceiling – which is laid down in Protocol No 11 to the EC Treaty and thus enshrined in primary European law – not only in the event of a severe recession or natural disaster, but also in the case of any negative annual growth rate (potentially, even a small one) or very low GDP growth relative to its potential.

Moreover, specified were "all other relevant factors" to be taken into account when deciding on excessive deficits in accordance with Article 104 (3) EC. This is a long list of potential exceptional circumstances and grounds for exemption hindering the implementation of an excessive deficit procedure. These include "prevailing economic cycles", "policies in the context of the Lisbon agenda", measures "to foster research and development and innovation", "debt sustainability", "financial contributions to foster international solidarity", contributions to "achieving European policy goals, notably the unification of Europe" (in other words: including payments relating to German reunification) and many more. Faced with this list, it is difficult to speak of a consistent, coherent set of rules.

(3) The deadlines for the incentives and sanctions system have been extended, for example, for Council recommendations pursuant to Article 104 (7) of the EC Treaty, issuing a warning notice to member states in accordance with Article 104 (9), non-interest bearing deposits and, ultimately, fines (Article 104 (11)).

(4) Furthermore, the deadline for the correction of the excessive deficit was widened to up to two years in case of "special circumstances", which are identical to the "other relevant factors" mentioned above.

(5) One change which is more significant than the extension of deadlines but has received less public attention is the possibility now provided for **repeating procedural steps.** In the event of "unexpected" economic events, Council recommendations may be repeated and a warning notice reissued any number of times.[24]

As a result, the sequential nature of the incentives and sanctions system, whereby each measure is succeeded by a more stringent one, is lost. However, the sequential nature of the old pact was also limited given that the European Court of Justice [25] had also accepted (albeit within the bounds of an action brought against the Council for failure to act) the possibility of virtual inaction on the part of the ECOFIN Council – for example, through the rejection of Commission proposals for Council recommendations.

An overall assessment of the changes to the two Regulations relating to the pact must find that there is no evidence – at least not in any operationally viable form – of the initially publicly stated reason for "reforming" the pact, namely to strengthen the preventive arm.

The introduction of a "benchmark" of 0.5% of GDP for annual cyclically adjusted budgetary consolidation[26] corresponds to the Commission's former practice regarding the old pact. However, it is likely to be less effective given that the objective of budgetary discipline has given way to a movable

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[22] Paragraph 5 of the recitals.

[23] See Otmar Issing (2005), *Speech at the International Research Forum on monetary policy*.

[24] See Article 3 (5) added, Article 5 (2) added.

[25] See ECJ, C-20/04 (FN4).

[26] See Article 5 (1) added, Article 3 (4) added.

target and scarcely a single policy area remains which <u>cannot</u> be classified under "relevant factors" or special circumstances to be considered when deciding on excessive deficits.

The <u>economic rationale</u> of the new version, much cited by politicians in opposition to a "legal interpretation", does not bear up on closer examination. For example, the flexibility provided for setting the medium-term budgetary targets reduces the margin to the 3% ceiling and thus increases the danger of exceeding this ceiling during an economic downturn. There are no corresponding operational rules providing in a legally binding way for greater adjustment during an economic upturn. Nor is there any plausible explanation as to why expenditure in the context of the Lisbon agenda – which contains no less than 8 key initiatives, more than 20 integrated guidelines for growth and jobs and more than 100 individual measures[27] – should have a different weighting when assessing a deficit than spending in those policy areas which are not listed, few though they are (for example, national antiterrorist measures). A general point that needs to be made in connection with applying the 3% ceiling is that both the logic and the applicability of a rule would appear to be called into question when more cases exist in which exceptions apply, rather than the rule itself.

An <u>institutional assessment</u> of the revised pact shows that the Commission now has considerably more scope for discretion and flexibility in its interpretation than it did under the old pact. Whether the Commission will be able to withstand the temptation to offer member states a benevolent interpretation of the "relevant factors" and exempting clauses in return for a *quid pro quo* in other areas (for example, a willingness to compromise on the question of the subsidiarity principle or projects with a budgetary impact) is a question that can only be answered in the light of political experience.

I would like to **conclude** by recalling that long before the start of monetary union, around the time of the "Delors Group" consultations in 1989, there was a common consensus that fiscal-policy rules and sanctions are essential for the long term viability of a single monetary policy.[28] The real "aim" <u>behind</u> budgetary discipline, <u>behind</u> the objectives of a rule-based fiscal policy, is to maintain and strengthen **confidence**. Firm rules are designed to make this easier – this is also the socio-economic purpose of institutions. The more the rules are relaxed the less relief they provide. As a result, the relevant actors and the central banks of the Eurosystem face greater demands and challenges.

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[27] See for example Hans Werner Sinn's contribution in CESifo Forum 2/2005.

[28] Hans Tietmeyer, *Herausforderung Euro 2004*, 124ff.