Europe's Quest for Fiscal Discipline

Will the Stability and Growth Pact help Europe find the right balance between fiscal discipline and flexibility?

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WHILE THE euro area's monetary policy is conducted by a single institution—the European Central Bank (ECB)—fiscal policy remains decentralized. When Europe's leaders agreed to form the Economic and Monetary Union (EMU) in 1989, they recognized the need for some form of fiscal coordination. Without coordination, the irresponsible policies of one member state could have a negative impact on the entire union, for example, by raising public debt. The Stability and Growth Pact (SGP), setting out regulations for the conduct of fiscal policy that reinforce the provisions of the Maastricht Treaty, was therefore agreed to by member states in 1997, nearly two years before stage three of EMU, when exchange rates were irrevocably locked.

But seven years later, the SGP is mired in controversy. France and Germany—the euro area's largest economies, founding members of the European Union (EU), and the main driving force behind the creation of EMU—are likely to breach the pact's deficit ceiling of 3 percent of GDP for the third year in a row. In November 2003, the European Commission—the official guardian of the EU's treaties—recommended that both France and Germany be placed under enhanced fiscal surveillance, one step short of actual sanctions. However, the Council of Economic and Financial Affairs (ECOFIN)—the decision-making forum for the EU's ministers of finance and economics—suspended the excessive-deficit procedures against the two countries, effectively sidestepping the SGP's rules and leaving the pact in a legal limbo. As it was unclear by what authority the Council acted when it decided not to take action, the European Commission took the case to the European Court of Justice.

Not surprisingly, the SGP is increasingly becoming a lightning rod for pundits debating its economic and political merits. Critics argue that besides being hard to enforce, the pact promotes procyclical fiscal policies (that is, it forces countries to reduce deficits during cyclical downturns) and lacks a rationale for its medium-term goal of bringing the underlying fiscal deficit close to balance or into surplus. Supporters, however, think the pact should be credited with controlling Europe's fiscal deficits. They also point to the countercyclical behavior of fiscal deficits since the introduction of the euro and note that most member countries have managed to live up to their commitments under the pact. Proposed solutions and blueprints abound, ranging from minor tinkering to completely rewriting the pact. This article tries to shed light on the controversy by reviewing the history of Europe's fiscal policy before and after the pact. It concludes with some thoughts on possible reforms.

Europe's fiscal past

Prior to the signing of the Maastricht Treaty in 1992, fiscal policies in EU member countries were widely divergent. Some countries ran large and persistent deficits that fed into rapid public debt accumulation, while others preserved a remarkable degree of fiscal discipline. By the early 1990s, gross public debts in Belgium, Greece, Ireland, and Italy had spiraled to over 100 percent of GDP, with fiscal policies on a clearly unsustainable path. At the other end of the spectrum, public debt accumulation in Germany and France was kept well in check. Given many prospective EMU members' apparent inability to maintain fiscal discipline, Germany, in particular, insisted on a common fiscal framework to rein in

Box 1

What is the Stability and Growth Pact?

The SGP consists of two regulations and a resolution agreed by the European Council to underpin the fiscal framework of the Maastricht Treaty. It combines discipline and flexibility by requiring countries to reach fiscal positions "close to balance or in surplus" over the medium term (a reference to the underlying or structural fiscal position) and keep their actual deficits below 3 percent of GDP, except in the case of unusually large shocks. Member states submit annual plans for public finances over the medium term. The Council offers opinions on them and, if necessary, delivers early warnings. Unless exceptional circumstances apply, the excessive-deficit procedure is initiated when a country's deficit exceeds 3 percent of GDP. The procedure starts with a recommendation to reduce the deficit, moves on to enhanced fiscal surveillance, and culminates in the imposition of financial sanctions. If no action is taken along the way, sanctions can be imposed within 10 months of the procedure being initiated. If excessive deficits persist, sanctions can be converted into fines after two years.

the spending of profligate countries before the euro was allowed to replace national currencies.

These deliberations resulted in two key provisions in the Maastricht Treaty, which state that fiscal deficits should be kept below 3 percent of GDP and debt ratios should not exceed 60 percent. To ensure compliance, member countries also agreed on a preventive arm focused on multilateral surveillance and a dissuasive arm for addressing "excessive deficits." The SGP was agreed nearly two years before stage three of EMU and provides more detailed guidance on implementing the Maastricht provisions on fiscal discipline (see Box 1).

One way to understand what the SGP was designed to do is to look at a matrix on fiscal discipline and flexibility—the two key objectives of a successful fiscal policy rule. Even though fiscal policy frameworks differ widely across countries, they can be evaluated using the same two criteria: Is the policy framework capable of ensuring medium-term fiscal discipline? Is it flexible enough to help smooth short-term business cycle fluctuations? These two criteria suggest a broad four-way classification of policy outcomes (see Box 2).

Box 2
Thinking inside the box

The ideal fiscal rule (quadrant A) enables a country to achieve fiscal discipline over the medium term while allowing enough flexibility to smooth business cycle fluctuations over the short term.

		Medium-term fiscal discipline: Yes	Medium-term fiscal discipline: No
Short-term fiscal flexibility	Yes	A: Ideal fiscal framework	B: Countercyclical but anchorless fiscal framework
	No	C: Overly rigid, procyclical fiscal framework	D: Poor fiscal framework, policy drift

The upper left quadrant (A) illustrates "fiscal nirvana"—the outcome most prized and hoped for by architects of fiscal policy rules—delivering both medium-term discipline and short-term flexibility. The lower right quadrant (D) depicts the worst possible fiscal policy outcome, namely, a lack of both discipline and flexibility. The two other quadrants (B and C) contain the mixed cases, with the lower left quadrant (C) illustrating what is probably a fairly common occurrence: a policy framework that delivers fiscal discipline but does not help stabilize the economy.

Supporters of the SGP argue that the pact, in principle, allows countries to occupy quadrant A on the grounds that underlying (or structural) balance provides a large enough cushion to allow automatic stabilizers to operate fully without normally breaching the 3 percent limit. Furthermore, the requirement of keeping the underlying budget position close to balance or in surplus is justified, they say, by fiscal sustainability considerations—including future expectations of large fiscal costs related to aging. However, critics question the concept of underlying balance, which they say is unrelated to the fundamental issue of fiscal sustainability. They also say there is no economic rationale for the debt ratio to converge (in theory at least) toward zero. Moreover, they argue, the pact would, at best, nudge fiscal policy into the less-than-ideal quadrant C, as the fixation on nominal balances constrains fiscal policy flexibility.

But what was the starting point for Europe? While the pre-EMU record on fiscal discipline across countries was mixed, there is considerable evidence that most EU countries ran highly procyclical fiscal policies during the 1980s and 1990s (deficits during the latter period reflected, to some degree, efforts to meet the 3 percent deficit limit by 1997). In particular, the estimated discretionary fiscal response of the general government balance to output growth was negative for all EU countries, bar the Scandinavian ones (see Chart 1). In four countries (Belgium, Germany, Ireland, and Italy), policy procyclicality was large enough to more than fully offset the automatic fiscal stabilizers. Procyclical fiscal leakages were particularly severe during "good times," when high growth softens fiscal constraints. In sum, most countries occupied quadrants C and D of the discipline-flexibility taxonomy. In fact, some of the countries with the most procyclical policies were also those with the least fiscal discipline, landing them squarely in quadrant D—reflecting the worst possible outcome for fiscal policy. Other countries gravitated toward quadrant C, given that maintaining fiscal discipline in no way guaranteed short-run fiscal flexibility with respect to the cycle.

Assessing the pact's performance

Given the dismal historical starting points of most member countries, it is hard to see how the pact would not have improved fiscal policy behavior. In its design, the SGP clearly puts the emphasis on maintaining fiscal discipline. Thus, combining discipline with anticyclical flexibility in the short run would require a significant measure of forward-looking fiscal policy management, particularly by allowing fiscal stabilizers to operate during good times.

So what does the track record of the pact over the past five years show? By the time the euro was introduced in 1999, all 12 euro area countries had succeeded in reducing their deficits to below 3 percent of GDP. A good one-third of the countries were running surpluses, including some that had a history of high public debt accumulation. Nevertheless, initial fiscal positions in most countries were not in line with the pact's requirement that fiscal positions be close to balance or in surplus over the medium term—something that did not augur well for the future.

But despite worries about the short-term nature of measures implemented by some member countries to comply with the deficit ceiling, the pact proved conducive to fiscal discipline—at least generally speaking. Looking at the big picture, the average euro area deficit during the euro's first five years stood at 1½ percent of GDP, a full 3 percentage points lower than the prepact average from 1980 onward. Indeed, from a sustainability perspective, the euro area's fiscal position over the past few years compares favorably with that of other major currency areas. At under 3 percent of GDP, the

area's structural fiscal deficit in 2003 was less than half that of the United States and less than one-fourth of Japan's.

In another major turnaround of policy behavior, the pact also caused fiscal policy to become distinctly less procyclical in most, if not all, euro area countries. Looking at the most recent business cycle (1999–2003), the structural fiscal balance of the euro area barely budged while fiscal deficits increased, as automatic fiscal stabilizers were generally allowed to operate unhindered (see Chart 2).

Also during this period, however, a gulf emerged between large and small countries. While the structural balance improved by more than 1 percent of GDP in the nine small countries, it deteriorated by roughly the same amount in the three large countries (see Chart 3). In particular, Italy, France, and Germany allowed their underlying fiscal positions to slip during the slowdown, starting from an already unfavorable level in 1999. In contrast, the small countries, as a group, continued to consolidate during the slowdown. In sum, the pact seems to have worked well for countries that found external commitments to be a valuable disciplining device. As a result, a new dichotomy replaced the old high debt–low debt nexus: With the large countries seemingly unwilling to push for underlying balance, the small countries seized the mantle of fiscal rectitude by sticking to their commitments under the pact. Even more ironically, France and Germany—the traditional bastions of fiscal stability in the prepact era—together with Portugal became the first test cases for the pact's excessive-deficit procedure.

So the pact did unquestionably deliver a high—but certainly not perfect—degree of fiscal flexibility during the downturn. On the issue of fiscal discipline, the track record is more mixed. Clearly, none of the euro area's member countries reverted to the lack of fiscal discipline prevalent before the pact. At least from a historical perspective, therefore, one could argue that under the pact's influence most countries seem to be gravitating toward quadrant A. By the pact's own standards of fiscal discipline, however, much remains to be done before quadrant A "membership" can be certified. In particular, several countries—including the largest—failed to reach "secure" underlying positions before the slowdown began and, in addition, allowed their structural deficits to slip further during the downturn. With automatic stabilizers largely allowed to operate, the resulting fiscal outcomes were repeated breaches of the 3 percent deficit limit by these countries. Moreover, most of the high-debt countries—the "original sinners" that provided the main impetus for having a pact in the first place—made only limited progress in bringing debt levels in line with the treaty's 60 percent of GDP reference value.

Problems of enforcement

The application of the SGP's enforcement procedures has certainly not been smooth. When Portugal and Germany looked set to exceed the deficit limit in early 2002, ECOFIN refrained from issuing early warnings despite calls to do so from the Commission. Both countries ended up breaching the 3 percent limit, in 2001 and 2002, respectively. But when France exceeded the limit in January 2003, it did receive a warning. ECOFIN also acknowledged excessive deficits in Portugal in November 2002, Germany in January 2003, and France in June 2003.

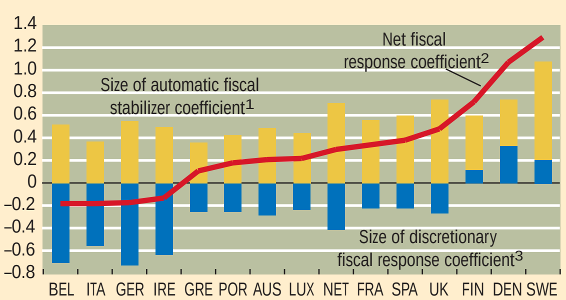
Countries reacted in different ways to ECOFIN's warnings. Portugal succeeded in reducing its deficit to under 3 percent in 2002 and 2003. France and Germany both failed to do the same. And while ECOFIN acknowledged in June 2003 that Germany had taken measures worth 1 percent of GDP, it soon became clear that the excessive deficit would persist in 2004. Likewise, France made little headway, and its deficit is now also expected to persist for the third consecutive year.

Against this background, the pact's procedural machinery broke down in November 2003. Citing France's and Germany's failure to curb excessive deficits, the Commission recommended stepping up the pressure. First, the countries

Chart 1

Cyclical behavior

Several countries ran fiscal policies that more than offset automatic fiscal stabilizers before Economic and Monetary Union, thereby increasing the problem of procyclicality.

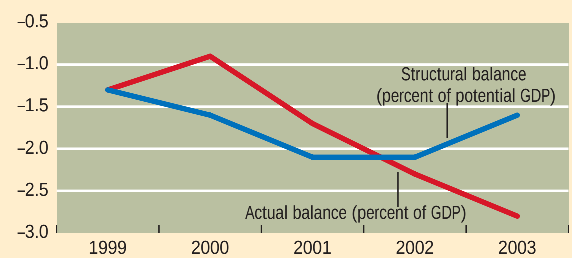


Source: IMF staff estimates.
Note: BEL=Belgium, ITA=Italy, GER=Germany, IRE=Ireland, GRE=Greece, POR=Portugal, AUS=Austria, LUX=Luxembourg, NET=Netherlands, FRA=France, SPA=Spain, UK=United Kingdom, FIN=Finland, DEN=Denmark, SWE=Sweden.
[1]Automatic change in ratio of general government balance to GDP in response to a 1 percentage point increase in real GDP growth.
[2]Sum of automatic fiscal stabilizer and discretionary fiscal response coefficients.
[3]Discretionary change in ratio of general government balance to GDP in response to a 1 percentage point increase in real GDP growth.

Chart 2

A major turnaround

The pact has caused fiscal policy to become distinctly less procyclical in most, if not all, euro area countries.



Source: IMF, *World Economic Outlook, April 2004*.

would be requested to reduce their cyclically adjusted deficits in 2004—by 1 percent of GDP for France and by 0.8 percent of GDP for Germany. Second, recognizing adverse economic circumstances, the Commission proposed giving the two countries an extra year (until 2005) to eliminate their excessive deficits. Third, the countries would be placed under enhanced fiscal surveillance and required to submit regular progress reports. But ECOFIN did not endorse this strategy. Instead, while agreeing with the Commission on the need to eliminate the excessive deficits by 2005, it effectively suspended the legal framework.

The differences between the Commission and ECOFIN on what constitutes a desirable fiscal policy are not significant. Indeed, ECOFIN could have altered the size of the adjustment or the time frame needed to eliminate the excessive deficit—all the while remaining within the legal framework. But, by failing to take action within the framework, it induced the Commission to ask the European Court of Justice to rule on the matter.

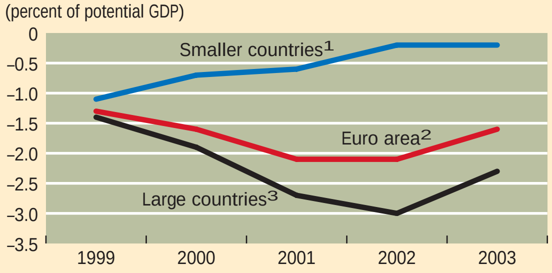
What next?

Given this mixed track record, what should happen to the pact? Should the limits on fiscal deficits and debt simply be dropped, as some have argued? With the euro area facing a serious fiscal sustainability problem, its strong preference for a welfare state ring-fenced by strict financial discipline is understandable. In this light, the medium- to long-term dimensions of the pact fulfill a valid function that is generally accepted by member states. Looking back, the experience with rapid public debt accumulation in some member countries reinforces the need for strict limits on fiscal deficits and debt. Looking to the future, maintaining fiscal discipline will be even more important, given the enormous unfunded liabilities associated with aging populations in most member countries. Finally, a framework emphasizing fiscal discipline would also prove particularly valuable to the 10 new member states that joined the EU on May 1—some of which are burdened by high current transfers and widening fiscal deficits that, if unchecked, will dampen long-term growth prospects.

Chart 3

Leading by example?

While the euro area's smaller economies are fulfilling the requirements of the Stability and Growth Pact, the large countries have actually increased their structural deficits.



Source: IMF, *World Economic Outlook, April 2004*.
[1]Austria, Belgium, Finland, Greece, Ireland, Netherlands, Portugal, Spain.
[2]Excludes Luxembourg.
[3]Germany, France, Italy.

While these factors speak against relaxing the main parameters of the Maastricht Treaty, the pact should be politically credible and economically meaningful. In this regard, potential reforms to the SGP could usefully be evaluated against three criteria. First, reforms should reduce the chances that countries with strong and proven domestic fiscal governance structures get entangled in protracted excessive-deficit procedures that quickly lead to sanctions. Second, reforms should help push higher-debt countries toward adopting stronger fiscal adjustment strategies. And, third, given that a significant number of countries have already aligned their fiscal policies with the SGP, potential reforms should preserve the incentives to maintain fiscal discipline. In the light of these criteria, a reform strategy could focus on the following planks:

- *More emphasis on symmetric implementation of the SGP during good times*, which means beefing up the pact's preventive arm. Had France and Germany attained "close to balance or in surplus" positions during the upswing (1999–2000), as did several of the other euro area countries, their fiscal positions might not have triggered the excessive-deficit procedure. Specific measures to this end would include developing better measures of structural balance, encouraging "rainy day funds," and replacing pay-as-you-go (PAYG) financing mechanisms with prefunding or more tax smoothing. Early enforcement could also be encouraged by using "national watchdog" institutions that can exercise moral suasion over their governments' fiscal policy behavior.
- *A less rigid procedure for dealing with excessive deficits* so that it is easier to distinguish between patent fiscal policy misbehavior and deficit overshoots that result from protracted weak growth. Although the SGP already has significant built-in procedural flexibility, its dissuasive arm could be softened, for example, by relaxing the rather strict conditions in which "exceptional circumstances" apply.
- *A stronger role for fiscal sustainability considerations.* Flexibility should also be enhanced at the preventive stage by including country-specific sustainability issues in determining the numerical targets for the "close to balance or in surplus" condition. This would imply a greater role for initial debt levels, as well as implicit pension liabilities.

For Europe, the challenge ahead will be to find a better balance between enforcing discipline and allowing flexibility. To do this, the pact may have to evolve further. In particular, for the sake of the pact's credibility, the present procedural impasse needs to be resolved quickly. Otherwise, some of the smaller member countries, aggrieved by what they perceive as double standards, might be less inclined to respect the pact in the future—and there are early signs that this is already occurring. However, it is also clear that there are limits on how far reforms can go in practice, given that 25 member states will have to agree on any reform package. ■

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