EU FISCAL POLICY AND THE STABILITY AND GROWTH PACT: NECESSARY EVIL OR POLICY MAKER'S NEMESIS?

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With monetary policy being controlled by ECB, fiscal policy is especially important for the EU countries. However, the extent of fiscal stimuli has been limited somewhat by the criteria laid down by the Stability and Growth Pact. While fiscal stability helps promote macroeconomic stability, one of the three pillars of the New Consensus policy, stringent limits on the level of external debt can be detrimental in certain situations. In this essay, Michelle Dalton critically examines the rationale behind the Pact as well as its merits and limitations, and suggests possible enhancing modifications.

Introduction

The role of fiscal policy within the EU has changed considerably over the past few decades. Damaged post-war economies and the subsequent oil crisis in the early 1970s demanded a thoroughly Keynesian response centred on expansionary fiscal policy to try and initiate economic recovery. However, the Maastricht criteria for EMU membership heralded a period of sharp fiscal consolidation on the part of member states in order to shape up for the arrival of the Euro. It is this 'new consensus' paradigm that the EU hopes to continue through the SGP. However, while some may view it as a necessary evil to constrain a country's spending capacity for the greater good, the issue of whether the agreement is sufficiently flexible to cope with fluctuations is difficult to get away from. In this essay, firstly a brief overview of the potency of fiscal policy is offered. Next the issues facing the role of fiscal policy in Europe are highlighted. Then the central components of the pact are outlined, and the necessity of the SGP is examined. Finally, the flexibility problem is addressed, as are possible alternatives, which may provide fiscal discipline without the same level of constraint.

The Role and Relevance of Fiscal Policy

Ever since Malthus' seminal elucidation of 'general gluts', or in today's parlance economic slumps, government expenditure has been used as a counter-cyclical tool to stimulate flagging economies. However, fiscal policy is by no means a panacea. There are serious difficulties in implementing a successful package, and just like any tool at a government's disposal, it is open to abuse. The Lucas Critique offers a warning that demand management could prove ineffective. The hypothesis of rational expectations dictates that individuals may revise their expectations when a new policy is implemented and so the effects may be very difficult to predict. In addition there is the problem of Ricardian Equivalence, whereby households and firms may believe that an increase in government spending will lead to tax increases in the future and so a fiscal expansion will not have the desired stimulatory effect. Furthermore, the crowding out problem of private spending and investment being forced out by higher interest rates is also an issue, as are what Friedman terms recognition lags, decision lags and effectiveness lags. But perhaps the most dangerous consequence of all, is that of political cycles, whereby governments reduce taxes or increase spending, even when it is clearly the most economically unsuitable thing to do, simply for political reasons.

What is perhaps most necessary in Europe's fiscal policy approach is balance. It intrinsically has two central functions. The role it assumes must be adequate enough to allow individual member states to compensate for the 'one size fits all' monetary policy. However, its approach must also seek to minimise the dangers of fiscal policy as outlined above, with particular regard to the issue of sustainability of government spending. The dangers of debt accumulation are alluded to by Miles and Scott (2002), who note that in OECD countries debt levels have risen sharply over time. In 1960, in developed countries government spending was around 30% of GDP. Now the figure is more like 50-60%. Because of this trend, which is particularly acute in Europe, interest payments have increased on average threefold.

The problem of the ageing European population also has serious repercussions for the EU's fiscal position. In many member states there is a predicted doubling of dependency ratios by 2040, which will lead to an escalation of pension expenditure as more people retire. Thus, current fiscal policy needs to make preparations to enable members to cope with this future burden.

The ECB (2000) also contends that: "fiscal sustainability will be a key condition for monetary stability in the future". Therefore, to ensure the success of the common monetary policy, it is clear that some sort of co-ordinated fiscal approach is required. Through the peer appraisal approach of the BEPG, the EU can keep an eye on fiscal issues, but a narrower framework is also needed. Intrinsically the role of fiscal policy in Europe is very much a compromise between allowing individual states to have autonomy regarding fiscal matters, and the need for co-ordinated economic stability throughout the EU.

The Need for the SGP? – Defining the Role of Fiscal Policy

There are essentially two main elements to the EU Stability and Growth Pact. Firstly, countries are required to keep their current accounts close to balance or in surplus over the medium term. Secondly, Article III-76 states that no 'excessive deficits' are tolerated in the short run (i.e. on an annual basis), where excessive is deemed to be a negative balance greater than 3%. However, there are some safety valves inherent in the plan, namely that in the case of a steep recession where GDP falls by more than 2% in a year, the conditions of the pact can be broken. Similarly if the fall in output is in excess of 0.75% (but not greater than 2%), a country might be granted a reprieve.

With the necessary trimming of fiscal indulgence in order to meet the Maastricht Treaty criteria now fading in the minds of Finance Ministers, a German-led initiative believed that some countries may now let their fiscal stance loosen, causing severe problems for other member states in the Euro area. Thus in 1997, we had the birth of the SGP. And while the aim of the continuation of the fiscal prudence that dominated the 1990s was a central *raison d'être* for the pact, it was not the only one. By the very nature of EMU, member states had to relinquish control over monetary policy. As a result fiscal policy has grown in stature, becoming the only tool that national governments can use when faced with difficult economic circumstances. As Willett (1999) asserts, the 'one size fits all' approach of EMU, has meant that the idea of members surrendering their fiscal autonomy to the EU as well, was definitely a step too far in European economic integration. Politics aside, there are vital economic principles at stake also; a low ECB-set interest rate may not suit the economic circumstances in all member states. This, coupled with the concept of subsidiarity, is essentially the reason why fiscal policy remains at the national level. However, given the economic circumstances within the EU, there is certainly a need for significant coordination of some sort. The SGP therefore dictates the parameters through which fiscal policy can be effectual, and ultimately curtails its role as a stabilising force in the Euro area.

The rationale for fiscal coordination also stems from the existence of international spillovers; excessive deficits may damage the entire Euro area and not just the individual country in question. The threat of moral hazard also exists, as Beetsman (1999) mentions that some members may be less inclined to restrain debt in the knowledge that although it is strictly condemned by the EU, other member states will be forced to bail them out, as this is a far less painful solution than the possible collapse of the EU banking system (which could arise as a result of a run on a country's debt). Furthermore, as the Mundell-Fleming model shows that the role of fiscal policy is heightened in a fixed exchange rate system (such as EMU), fiscal policy may be a more tempting option and one which governments may abuse, especially in the year preceding elections.

So the question remains, can countries afford to keep running deficits when they already have accumulated a wealth of debt? The answer is clearly no, and consequently fiscal policy in the Euro zone, through the SGP, recognises this role.

The Flexibility of the SGP

As previously stated, fiscal policy is not a cure for all ills, and indeed if it is used excessively the results can be distinctly non-Keynesian.[1] Therefore, perhaps the SGP has a valid point: If countries are going to run up relatively large deficits regularly, fiscal expansion will not have the desired effect, and it may become relatively ineffectual. The SGP will prevent this happening and it will allow some scope, albeit limited, for cushioning blows. If a country's structural budget is balanced, the SGP parameters will allow for the effects of automatic stabilisers, however is this scope enough?

De Grauwe (2003) claims the SGP "risks putting the clock back fifty years" by obtruding countries from using the built-in stabilising properties of government budgets to smooth out deep fluctuations. Consequently it is difficult to see the SGP as sufficiently flexible, and indeed Germany and France seem to agree. Both countries have breeched the pact in successive years and are now in danger of being fined anything up to 0.5% of GDP. However, it is difficult to accept the credibility of the pact when even the European Commission President Romano Prodi pronounced it as being "stupid". The Economist (2003) believes that the European Commission will allow France to break the limit in 2004, as long as they promise to begin to cut back in 2005. This however weakens the credibility of the pact. If certain countries can get away with breaking the ceilings, how are we to believe that the SGP is a serious agreement, which must be adhered to by all member states? It is certainly interesting to note that Germany, who was so active in initiating the pact, can now see its shortcomings.

[1] Hogan (2001) contends that after prolonged use fiscal policy no longer has a stimulatory effect on output as budget deficits lead to a fall in confidence levels and people anticipate increases in taxation.

Apart from the problems concerning the stabilisation function of fiscal policy, there are further implications of the pact. As De Grauwe contends (1997): “As countries will be hindered in their desire to use the automatic stabilisation in their budgets during recessions, they will increase their pressure on the ECB to relax monetary policy.” He continues to say that a central goal of the pact’s genesis was in fact to reduce this very threat, but in reality the agreement may actually “have increased the risk of such pressure” (Ibid).

Price stability seems to be the central tenet by which the ECB operates, and indeed if countries consistently run deficits, it will put great upward pressure on prices, reduce confidence in the economy, and possibly lead to an inflationary spiral. However, as we have seen since the inception of the pact, in Germany particularly, deflation can also be a problem. In this case a fiscal injection in excess of the guidelines in the SGP could prove helpful in trying to avoid the plague of deflation. When the economic climate is favourable the SGP seems to be rational and appropriate. If Europe is greeted with a stronger recession than the current situation, the pact will probably lead to an overly painful recovery. The pact seems rather myopic in failing to acknowledge this fact.

Furthermore, the aforementioned ageing population problem will eat heavily into public funds through increased pensions costs. This threat of a burgeoning debt does certainly need to be tempered; and at least if governments pursue a prudent policy of fiscal correction over the coming years (what the ECB terms “pre-emptive” action) the Debt/GDP ratio should still have some room to absorb extra borrowing as the situation worsens after 2020. However, as the problem worsens over the coming years, keeping budgets close to balance or in surplus may simply not be a tenable option for governments.

De Grauwe (2003) continues to underline the unsuitability of the SGP for every member state. He argues that even if the SGP guidelines make sense as a “temporary strategy for highly indebted countries like Belgium, Italy and Greece”, countries that do not have a debt problem, should not be made to adhere strictly to the plan.

Moreover, Hughes Hallett and McAdam (1999) also argue that the SGP may have long term effects which are even more far reaching than mere inflexibility:

> “Not only does constraining our ability to vary the policy mix constrain our ability to absorb shocks; it also destroys our ability to get precisely those longer term benefits (i.e. more investment and higher output potential) which these deficit reductions were designed to achieve” (Ibid).

By discouraging borrowing, governments may abandon very worthwhile investment projects which could, if initiated, significantly improve long term economic growth. The question of an appropriate debt level can surely only be meaningful if we ask what the debt is used for. Just as firms borrow money when they see a profitable opportunity, member states should also have the capacity to build up debt if it is self-liquidating over a future period. It does appear that, as Canzaneri and Diba (2001) conclude, the SGP is indeed an "albatross" rather than a "delicate balance".

But while we are criticising the SGP for being too rigid, it is interesting to note that fiscal policy itself is quite inflexible also; the problem of time lags means that even if countries were to have total control over fiscal policy, it may not be a very effective weapon, *vis-à-vis* monetary policy, if faced with a major recession. In addition, there are serious sustainability questions attached to the use of fiscal policy, and at the very least we must praise the pact for recognising this. In fact the International Monetary Fund (IMF) (1997) raises this point, by noting that the SGP may indeed constrain fiscal activism, but in a sense a history of high budget deficits and prolonged government spending has already done so:

> "Concerns about the potentially constraining effects on countries' ability to pursue counter-cyclical fiscal policies need to be put into the perspective of the constraints imposed by large deficits in most EU countries over much of the past 25 years".

Alternatives and Improvements

Several modifications could be introduced to the existing pact to make it more flexible. There is the option of using the Debt/GDP ratio as a yardstick, however Beetsman (1999) suggests that the Deficit/GDP measure is a much more immediate check, and it helps to stop current governments being punished for the negligence of previous governments. On the other hand, it would allow governments to use fiscal policy as they see fit, given the economic circumstances, while still underlining the need to pay back any loans.

He also contends that the reference deficit level (which is essentially arbitrarily set at 3%) should be contingent on the state of the economic climate. A more generous deficit should be allowed when the deviation of actual from potential GDP is bigger and vice versa. However, measuring the accuracy potential GDP with any degree of certitude is at best problematic, at worst impossible.

We could potentially go a step further however. Fischer and Giudice (2001) concur that perhaps the actual size of the fiscal correction is not as important as the composition of expenditure. Should the EU be emphasising a shift away from current transfers and public wages expenses, rather than outright spending control? They maintain that it is the 'quality' of public finances that really should be kept in check, and perhaps the EU should address this dimension of the fiscal policy debate.

Conclusion

As we have seen, EU fiscal policy as embodied by the SGP is far from a Utopian solution. While many of the problems that pervade economic recovery in Europe may indeed be structural in nature, the option of using expansionary fiscal policy as a short run cushion neither should not nor cannot be dismissed altogether. For many countries the pact will act as a fiscal straitjacket that may prove impossible to adhere to. Yet, even in its present incarnation, the SGP should at the very least ensure that its ethos is applied consistently and fairly in order to uphold the credibility of the pact, and indeed the credibility of European economic policy in general. The success of the pact in its current form will only be seen in the fullness of time, and optimistic economic forecasts for late 2004/2005 may help to extend the longevity of the agreement. However, perhaps when faced with the onslaught of something more pronounced than a mere tumble in short-run demand, we will see some serious and altogether necessary amendments to its restrictive essence.

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