The Stability and Growth Pact: Its Role and Future

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When, some years ago, a group of European countries decided to establish a European Monetary Union that would have a common currency and a European Central Bank, it faced the reality of significant differences in economic conditions among the member countries. These differences involved inflation rates, interest rates, levels and structures of public spending and revenue, and levels of fiscal deficits and public debts. Furthermore, the reputations of the policymakers of the countries were not similar, having been shaped by different past performances.

Some of these differences could be ignored, being of limited importance to the functioning of a monetary union. Some could be assumed to disappear automatically once the EMU came into existence. Some could be expected to be reduced by market forces. Some, however, were seen as central to the functioning of the EMU and requiring special attention. Among these were the countries' fiscal situations.

Monetary Unions and Fiscal Policy

These situations were widely different in terms of size of fiscal deficits and public debts. For example, in 1995, the year when new statistical definitions of the basic variables were introduced, to make them more comparable across countries, the net lending of the general government—the agreed-upon definition of fiscal outcomes—ranged from a positive value (a surplus) of 2.1 percent of GDP in Luxembourg to a negative value (a deficit) of 12.2 percent of

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GDP in Greece. The range in the shares of gross public debts as a percentage of GDP was even wider: from 6 percent in Luxemburg to 134 percent in Belgium and 123 percent in Italy.

The Need for Fiscal Coordination

There are various reasons to believe that in a monetary union fiscal policies need to be coordinated and improved. Some of these reasons are as follows.

First, an effective monetary policy, and especially one that has, as its main or only explicit objective, price stability, cannot tolerate major fiscal disequilibria. Good fiscal results are needed if long-run interest rates, which are fundamental for investment and economic growth, are to be low.

Second, as the experience of many countries indicates, the existence of large fiscal deficits and public debts inevitably creates strong pressures—on the part of finance ministers, and directed toward the monetary authorities—to keep discount rates low or, in extreme cases, to directly finance the fiscal deficits. When these pressures are not resisted, they end up compromising the objective of monetary stability.

Third, a monetary union creates a single market for financial capital. This implies that a country with a large fiscal deficit and public debt can access more easily the financial savings of other member countries to finance its own deficit and to service its own debt. This will raise the real rates of interest not only for the country but for all the members of the union—the deficit country can create negative externalities for other countries. Some member countries might be tempted to pursue more expansionary fiscal policies if part of the cost of servicing their public debt is borne by other countries.

Finally, in the long run, the performance of the euro, as an international currency capable of competing with the U.S. dollar, would be affected by the perception, on the part of those who operate in the international financial market, that the fiscal policies of some of the countries of the union are not sustainable. This would reduce the seigniorage of the EMU and, perhaps, contribute to maintaining higher real interest rates.

How to Achieve Coordination

The conclusion that in a monetary union the fiscal policies of the member countries need some control and coordination must be accompanied by a decision on how to achieve those objectives. There are two basic options.

First, and most optimistically, the coordination could be left to market forces. Some economists believe that market discipline, as

enforced by the decisions of rating agencies, would be sufficient to promote a behavior consistent with a necessary degree of fiscal coordination (see Goldstein and Woglom 1992, King 1992, and Tanzi 1992). In other words, they believe that policymakers are sensitive to changes, or to threatened changes, in credit ratings so that they adjust their behavior as needed. This conclusion assumes a highly responsible behavior on the part of policymakers and a capacity on their part to make needed policy changes. In reality, however, market discipline seems to become effective mainly when the fiscal situation of a country is so serious as to lead to drastic changes in ratings that effectively cut access to credit. For most situations, changes in fiscal conditions bring about only small changes in ratings and in interest rates as recent experiences in EU countries and in Japan indicate. The effects of these changes on interest rates are marginal and are not likely to change the fiscal behavior of governments.

The second option would be that of following some fiscal rule aimed at constraining fiscal policies. Fiscal rules have become more popular in the world in recent years (Kopits 2001). For thousands of years, and until recent decades, the fiscal rule considered most appropriate was that of budget balance. In 63 B.C., Cicero argued that "the budget should be balanced, the treasury should be refilled, public debt should be reduced" (quoted in Kopits 2001). Seventeen centuries later David Hume wrote: "The practice . . . of contracting debt will almost infallibly be abused in every government" (in Rotuein 1955). Therefore, "the consequences . . . must indeed, be one of . . . two events; either the nation must destroy public credit, or public credit will destroy the nation." Many other historical figures, including George Washington, held the same view. According to Washington, "there is no practice more dangerous than that of borrowing money" (quoted in *The Economist*, August 23, 2003, p. 11).

One could comment that most of these historical figures were not economists. However, their position on proper fiscal policy did not come from economic theorizing but from their real life observations of what often happened to countries that followed irresponsible fiscal policies. For us, today, it is not necessary to go back to historical examples to find countries that got into trouble when, in the words of Hume, they abused "the practice of contracting debt." There is no scarcity of recent examples.[1]

[1]The Keynesian attack on the balanced budget rule has made many modern economists consider this rule as a dangerous relic of primitive times. However, the majority of American states still follow some versions of it and there have been attempts in the U.S. Congress to introduce an amendment to the Constitution that would require a balanced budget. Also

It is not necessary to interpret Cicero's and Hume's rules as necessarily implying that the budget should be balanced every year. This is the version most easy to criticize. There could be situations (wars, natural disasters, major public works, business cycles) when a longer time frame would be preferable. After all, it is mainly accounting or political conventions that have established the practice of annual budgets. If budgets were prepared for longer periods, as they are in a few countries, the rule could require that they be balanced over these longer periods rather than annually.

In 1947, the Committee for Economic Development, a Washington think tank, introduced the view that the budget could be balanced over the cycle and not annually. The reasons were several. First, "businessmen preferred stable taxes as a condition for business planning." Second, there "was a profound skepticism about the balancing effect of changes in tax rates and expenditures." Third, "expenditures could not be increased quickly and usually could not be stopped quickly without much waste." Fourth, "the decision making process of tax changes in a political environment was likely to make this a pretty sluggish instrument." Finally, accurate forecasts could not be produced and official forecasts were often misleading. The Committee concluded that "keeping tax rates at a level where they would yield a moderate surplus at high employment would be more stabilizing than . . . the 'managed, compensatory policy.' "[2] As we shall see, the Stability and Growth Pact shares most of these conclusions.

In 1948, Milton Friedman also endorsed the view that, in countries that experienced business cycles, the budget could be balanced over the cycle and not annually. The budget would be allowed to be in deficit in years when economic activity was below its long-term trend and in surplus when economic activity was above the trend. The surpluses would finance the deficits thus preventing the growth of public debt. In this way countries would not need to take pro-cyclical actions to balance the budget every year. The budget would automatically exercise some countercyclical action. The strength of this action would depend on the elasticity of taxes and spending with respect to changes in national income.

If public officials knew the length and the behavior of the cycle and the automatic reaction of tax revenue and public spending to the cycle, they could prepare a budget that could be balanced over the

Article 81 of the Italian Constitution requires that public spending be always covered by revenue. However, the interpretation of that article has allowed Italy to acquire an enormous public debt. In 1992 Italy came close to defaulting on its public debt.

[2]All citations are from Stein (1969: 322).

cycle. In specific years fiscal deficits attributed exclusively to the cycle would be tolerated. Deficits larger than those described earlier would be attributed to "discretionary policies."

Structural versus Actual Budget Outcomes

The earlier description is at the basis of the distinction between structural and actual budgetary outcomes. This distinction is still central to the current discussion of fiscal policy. However though useful, it is far less firmly based than most economists realize.

First, business cycles are much less well behaved than would be desirable. Trend lines change frequently and cycles do not have the regular behavior that one would wish. Some are long, some short. Some are deep, some shallow. In practice it may be difficult to distinguish the effects of a cycle from those of changes in trends. Many assumptions must enter in the calculations. For example, was the behavior of the Japanese economy over the past decade due to a cycle or to a change in the trend? What is the meaning of a structural deficit in Japan?

Second, in many countries there are frequent discretionary changes, on the tax or the expenditure side of the budget, some difficult to identify, that introduce "noise" in the relationship between economic activity and fiscal variables. Especially for some countries such as Italy it becomes very difficult to separate the *automatic* effects of the cycle on the fiscal variables from the *discretionary* effects of policy changes.

For both of these reasons, in practice, if not in theory, the distinction between structural and actual deficits is fraught with difficulties and lends itself to potential manipulations and misinterpretations. Structural deficits cannot be used to provide a reliable rule to assess fiscal performance or behavior. That rule will likely be abused or be subject to different results depending on who interprets it. The recent decision on the part of the European Commission to allow countries to measure future corrections in their fiscal accounts by reference to the structural deficit may prove to be a mistake.

The Stability and Growth Pact

The framers of the SGP endorsed the view that the widely divergent trends in the public finances of the EU countries, and the different reputations of the governments, made it unwise to leave the process of fiscal convergence to the discretion of the individual countries' policymakers. Some limitation of that discretion was considered

necessary. However, the limitation should not be too constraining; it should leave the governments with considerable freedom in the pursuit of their fiscal actions.

As an important concession to the principle of subsidiarity, the SGP left countries free to have any level of public spending or taxation they desired. Thus, they could continue pursuing their own social policies. In this sense the SGP was much less constraining on the role of the public sector than, say, James Buchanan would have liked. The SGP imposed an upper limit of 60 percent of GDP for the debt of the general government, and an upper limit of 3 percent of GDP for the fiscal deficit of the general government. Countries were free to satisfy the requirements of the Pact through changes in taxes or in spending.

Because in 1997 several EMU countries (Belgium, Greece, Italy) had public debts *much* higher than 60 percent of GDP and some other countries had debts that exceeded 60 percent of GDP by smaller amounts, the rule was relaxed in the sense that, in future years, the ratio of public debt to GDP would need to converge toward the 60 percent level for countries that had higher levels. The speed of convergence was not specified but was left to the annual discussions of the countries' authorities with the European Commission. The implication was that the higher the public debt/GDP ratio was, the faster the process of convergence should be.

To appreciate the preoccupation with the level of public debt, it is necessary to recall what had happened to it before 1997, the year when the Maastricht criteria were agreed upon. For the combined EU12 countries, the debt/GDP ratio had risen *every year* since 1977. Between 1977 and 1997, the ratio increased from 31 percent to 75.4 percent and created a huge mass of public bonds that needed to be serviced, which caused significant problems for the monetary authorities. At the time at least three countries had fiscal policies that were considered unsustainable (see Table 1 and Figure 1).

The behavior of the public debt during the 20 years leading up to Maastricht suggested that the rule related to the fiscal deficit ought to be more constraining. A public debt of 75.4 percent of GDP that carried, say, an average interest rate of 6 percent per year would require a primary surplus of 4.5 percent of GDP just to pay the interest. This meant that the tax burden (and the marginal tax rates) needed to be considerably higher because of the high debt, which had a negative impact on the economy (Tanzi and Chalk 2000). The question of the sustainability of fiscal policy was not a theoretical one in 1997.

After the Maastricht agreement of 1997, the fiscal accounts of the EMU countries improved somewhat until 2000 or 2001. In this

TABLE 1
PUBLIC DEBT AS A PERCENTAGE OF GDP, 1997–2003

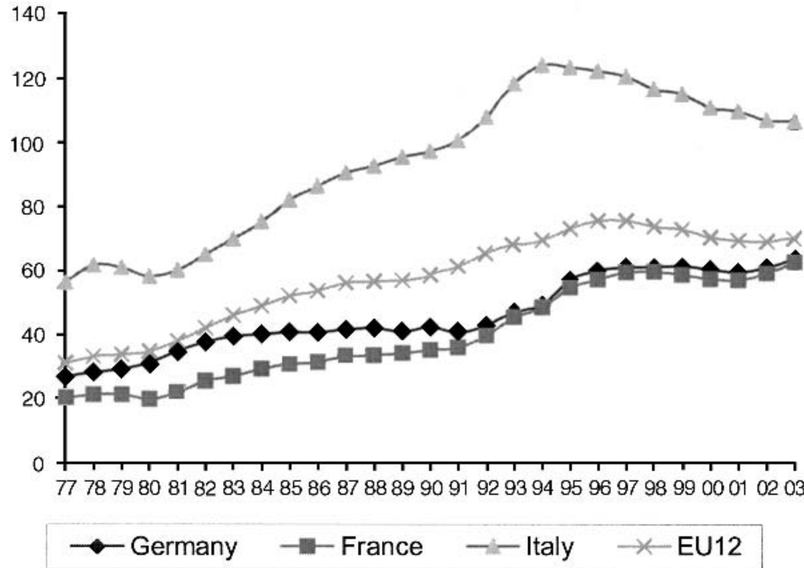
	Germany	France	Italy	EU12
1977	26.8	20.1	56.4	31.0
1978	28.2	21.2	61.7	33.1
1979	29.2	21.2	61.0	33.8
1980	31.2	19.8	58.2	34.7
1981	34.8	21.9	60.2	38.0
1982	37.7	25.5	65.1	42.1
1983	39.4	26.9	70.0	45.9
1984	40.1	29.1	75.2	48.9
1985	40.7	30.8	81.9	52.0
1986	40.6	31.3	86.2	53.7
1987	41.6	33.4	90.4	56.0
1988	42.0	33.4	92.6	56.5
1989	40.7	34.1	95.4	56.8
1990	42.3	35.1	97.2	58.1
1991	40.4	35.8	100.6	58.6
1992	42.9	39.6	107.7	61.9
1993	46.9	45.3	118.1	67.2
1994	49.3	48.4	123.8	69.5
1995	57.0	54.6	123.2	73.0
1996	59.8	57.1	122.1	75.4
1997	61.0	59.3	120.2	75.4
1998	60.9	59.5	116.3	73.7
1999	61.2	58.5	114.9	72.7
2000	60.2	57.2	110.6	70.2
2001	59.4	56.8	109.5	69.2
2002	60.8	59.0	106.7	69.0
2003	63.8	62.6	106.4	70.4

SOURCE: European Commission.

period there was some reduction in public debt although it remained a high share of GDP. By 2000, five of the smaller countries (Belgium, Ireland, Luxemburg, The Netherlands, and Finland) had improved their fiscal accounts enough to run surpluses. Of the other countries only Portugal had a fiscal deficit of more than 2 percent of GDP.

Between 2000 and 2003, however, there was a major fiscal deterioration in Germany (from a deficit of 1.2 percent of GDP to 4.2 percent of GDP), and in France (from 1.4 percent of GDP to 4.2 percent of GDP). In both countries the public debt grew significantly, and in 2003 it exceeded the 60 percent limit. In Italy the increase in the fiscal deficit was limited through the sale of public assets and the

FIGURE 1
PUBLIC DEBT AS A PERCENTAGE OF GDP, 1977–2003



use of tax and other amnesties, but its fiscal accounts remain fragile and its public debt is the highest among EMU countries.

By 2003 France and Germany had broken the 3 percent of GDP fiscal rule for the second consecutive year and were forecast to break it again in 2004, which would potentially subject them to heavy financial penalties. The decision on whether to impose the penalties is now subject to heated discussions that are dividing the countries of the EMU between those who would impose the penalties and those who would not. In the last analysis the decision will be made by the finance ministers of the countries and will, thus, be a political one.

The performance of the fiscal accounts of France and Germany has been attributed to the deteriorating performance of their economies. Thus, there has been a lot of sympathy for these countries' authorities and criticisms against the SGP, which has been described as excessively rigid. However, closer observation shows a somewhat different picture.

Broadly speaking, in the EU countries the average relationship between *changes* in economic activity and *changes* in the fiscal accounts is such that a fall in GDP of 1 percent leads to an *increase* in the fiscal deficit of about 0.5 percent of GDP (Van den Noord 2002). Thus, a country that started with a fiscal deficit close to zero would

need to experience a fall in GDP of 6 percent to break the SGP ceiling of 3 percent *if it let its built-in stabilizers react passively to the change in economic activity.* Such a large fall in GDP is far from what has been experienced by any EMU country in recent years and far from the fall experienced by France and Germany in the past couple years. Furthermore, if such a fall in GDP were ever experienced, it would be considered an "exceptional circumstance" that would justify a temporary relaxation of the SGP.

By historical standards the current slowdown in economic activity has been mild. There has been no real recession (IMF 2003). Therefore, the EMU countries have had considerable freedom in letting their automatic stabilizers operate fully, and even to engage in some discretionary fiscal policy, without breaking the 3 percent ceiling. In a recent paper, Gali and Perotti (2003: 28) have concluded that they could not find support in their empirical analysis for the popular view that SGP has "significantly impaired the ability of the EU governments to conduct an effective discretionary countercyclical policy."

The current fiscal situation of Germany and France is due far more to their fiscal policies than to the effect of the slowdown on their fiscal accounts. That those policies have not helped stabilize their economies is obvious. Of course, it did not help that in the 1997–2000 period, a time of sustained economic growth, a greater effort was not made to improve the fiscal accounts.

It is difficult to justify attacks on the SGP that define it as a "fetish" or even "stupid." These attacks reflect either a lack of understanding of the situation or condone the countries' inability to resist political pressures to increase spending or to cut taxes. Alternatively these attacks may simply reflect a blind faith in the virtue and effectiveness of countercyclical fiscal policy.

Questioning Faith in Countercyclical Policy

In 2003, José Manuel Durâo Barroso, Prime Minister of Portugal, noted that the SGP "is like the legend of Ulysses." It "helps a government to tie itself to the mast and resist the sirens who are trying to lure us to destruction with seductive songs of more state spending and bigger bureaucracies" (quoted in the *Financial Times*, January 29, 2003, p. 2). In Europe political pressures are associated more with increasing public spending than with cutting taxes. Thus, in recent decades there has been a rise in public spending and taxes as a percentage of GDP.

In the last couple years countercyclical fiscal policy has come back in fashion in a way that would have seemed inconceivable a few years

ago. The "stagflation" of the 1970s has been quickly forgotten and, now, it is often stated that the existence of an output gap or higher unemployment is a guarantee that very expansionary fiscal and monetary policies cannot bring about inflation but only generate real growth.

It seems that the impact of the economic literature of the past three decades has been close to zero and Keynesian economics has returned to dominate the world of policymaking. Recoveries are now attributed exclusively to countercyclical policies, forgetting that all cycles eventually end and that some end without recourse to countercyclical policies. It is also forgotten that the countries that have not given into the "seductive songs" of "sirens" are those that are doing best.

Countercyclical fiscal policy is more likely to be effective when a country with initial good fiscal accounts uses it, than when it is used by countries in which the debt/GDP ratio grew almost continuously over a 25-year period. Furthermore, an implicit and fundamental assumption of countercyclical fiscal policy is that taxes and public spending *can be changed with the same facility in both directions and in short periods of time.*

The reality is that in many countries there is an asymmetry in the use of fiscal instruments. It is generally far easier for governments to cut taxes and to spend more than to do the reverse. The bias that this asymmetry introduces in fiscal policy has rarely been incorporated in the discussions of countercyclical fiscal policy. That is the reason why many countries end up with large structural fiscal deficits and public debts. It is also the reason why countries often fail to use periods of economic expansion to bring their fiscal accounts under control. That is the main justification for the SGP.

Finally, even when governments are able to change the fiscal variables in both directions, the question of timing remains. The lags may be far longer than desirable and fiscal actions may tend to be counterproductive. That aspect was much discussed in the literature in the past, but it has almost disappeared from current discussions. Having represented the Italian government in the Budget Commissions of the Italian Parliament, I have become acutely aware of the time it takes for laws to work their way through the various committees and to come to the full floor of parliament for final decisions. That time is likely to be longer when restrictive fiscal proposals are made than when expansionary proposals are made.

The Future of the Stability and Growth Pact

I earlier argued that the SGP was a necessary rule in the context of the European environment and the past fiscal performance of several

EMU countries. It is easy to forget that the public debt of Belgium reached 138.2 percent of GDP in 1993, that of Italy 123.8 percent of GDP in 1994, and that of Greece 111.3 percent of GDP in 1996. In 1992 Italy had come close to defaulting on its debt. It is also easy to forget that the fiscal deficit of Greece reached 15.9 percent of GDP in 1990, that of Belgium 12.5 percent of GDP in 1981, that of Ireland 12.6 percent of GDP in 1982, and that of Italy 12.5 percent of GDP in 1985. Those levels were not reached because of wars, huge public investments, or depressions. They were reached because of political pressures on the governments to spend more. Furthermore, they were reached while the level of taxation was increasing sharply in most of these countries.

Fiscal rules that reduce the freedom of governments to pursue countercyclical policies may not be needed when policymakers are responsible and have control of the fiscal instruments. In this case they would probably pursue reasonable fiscal policies. It can also be argued that in the absence of these two conditions no fiscal rule would help unless it were totally and constitutionally binding.

In reality, few countries find themselves in these two extreme conditions and certainly not the European countries. The policymakers of these countries would consider themselves responsible but would admit that they have only partial control of fiscal instruments. Political obstacles often reduce their control over fiscal instruments. For these countries the existence of a rule that leaves them some discretion but ties them to the "mast" to resist the "seductive songs of the sirens" that want more spending can be useful, and may become even more useful in the future because of pressures that will be felt by many countries.

Some of these pressures will come from demographic developments. Some will come from the impact of globalization on tax systems. I have argued in several articles that it will become progressively more difficult in future years to maintain the levels of taxation now common in many European countries (Tanzi 2002).

The conflict between the need to spend more and the likely fall in tax revenue could increase pressures on European governments to run up, and to justify, larger fiscal deficits. The governments could argue that the larger deficits are justified by countercyclical fiscal policy, or by the need for infrastructures, or for some other useful spending such as research or even defense. Those justifications are being heard with increasing frequency. Those are precisely the conditions in which an effective fiscal rule is needed.

Still there remains the question of what to do with the countries that have broken the fiscal ceilings, so far for two consecutive years

(France and Germany). It is not likely that, if they break the ceilings for a third year in 2004 as it seems likely, they will be penalized as required by the SGP. Those countries may be "too big to punish." One hopes that they will not use their political power to take a defiant attitude vis-à-vis the European Commission (counting on the political support of potential, future "sinners"). Such a position would encourage other countries, and specially the new members from Eastern and Central Europe, to ignore the existing fiscal rule. If that happened it could be a disaster for the future of the European Union and for the euro. Rather, these countries should negotiate with the EC a reasonable speed of adjustment and should introduce *soon* the policies needed to reenter within the limit of the SGP. The EC should be flexible as long as it is convinced of the good intentions of these countries' authorities to act in a fiscally responsible way in future years and as long as it is presented with realistic adjustment policies.

One final point. There is now much discussion about whether the SGP should be modified to introduce a "golden rule" that would exclude all investment from spending, exclude investments that have a European-wide character, exclude expenditure for research and development, and even exclude defense expenditures. Proposals have also been made to use a rule based exclusively on the ratio of public debt to GDP. At the same time accounting questions of how to measure the fiscal deficit continue to attract attention and are a source of friction between some countries and the EC. These issues are very important but are outside the scope of this article. Nevertheless, several observations are warranted.

First, a fiscal rule must be simple. When it gets complex, it leaves too much scope for maneuvering. Any of the changes suggested above would increase the complexity of the rule and reduce its transparency. All have the objective of allowing countries to spend more when they should be reducing the level of their spending to face future pressures. Second, as to the accounting question, it is useful to recall that at times the perfect is the enemy of the good. The move from the cash-based definition of the fiscal deficit to the accrual-based definition favored by statisticians has eliminated some problems but introduced others. As John Plender (2003: 18) writes, "The further the budget discussion moves from cash, the greater the risk of becoming lost in the fiscal fog of war." This is an area where further work by the EC is needed.

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