

Balancing the Stability pact

Jean Pisani-Ferry(*)

France's renewed commitment to reach structural budget balance by 2004 once again highlights the role of the Stability pact as the centrepiece of the European fiscal charter. Whatever their reservations, Italy, Germany and Portugal also recently had to abide by its rules.

As economists almost unanimously regard fiscal discipline as an essential tenet of a well-functioning monetary union, they may rejoice at this demonstration of rectitude. The Maastricht convergence criteria and the Stability pact have contributed a great deal to Europe's conversion to the culture of fiscal responsibility (or at least to the containment of the opposite temptations) and it is hard not to look back with satisfaction at this achievement.

The devil however hides in the details and we must question the operation and potential effects of the Stability pact. Since last Summer, the Ecofin has agreed on a new definition of the medium term objective which basically states that member states must reach structural budget balance by 2004 and stick to it thereafter. This means that budget balances may vary depending on the economic cycle, thereby providing the so-called 'automatic stabilisation' of fluctuations, but that governments should essentially keep expenditures at a level corresponding to 'normal' receipts.

There is much to commend in the *short term* properties of this framework. The initial Stability pact focused on the headline deficits without taking into account the effects of economic fluctuations, which had the unfortunate effect of giving governments an incentive to spend freely whatever receipts a booming economy could provide and to raise taxes in the midst of a recession. The recent correction, is a welcomed demonstration of collective wisdom.

There is however less to praise in the *long term* impact of our current definition of fiscal discipline. First, a balanced budget means that the current generation pays for the current expenditures, including when their benefits arise over the medium term. Fairness and efficiency may however require that a public investment in, say, cleaning up of the environment is partially paid for by the future generations who benefit from it, i.e. financed by debt. This approach could rightly be dismissed as merely theoretical as long as governments were in fact making future generations pay for benefits accruing to the present ones. But this is less and less the case. In 2001, the debt ratio declined in 11 of the 12 euro member states and it stands below 60% for 8 of them. 9 of the 12 accession countries, for which intergenerational equity especially matters, also record debt ratios below 60%.

If the Stability pact is effective, more and more countries will move to low-debt territories and the rationale for making current generations pay for *all* expenditures will weaken accordingly. This has already been recognised by the Ecofin which has given its seal of approval to the British medium term fiscal scenario, although it does envisage a deficit of 1% of GDP in 2005-2006. This is a recognition that a strict balanced budget rule cannot be enforced on a low-debt country which is investing in the improvement of public services.

There is a second reason for not being satisfied with the Pact. Unsustainable debt accumulation, rather than deficits, represents the real potential threat to monetary stability. Supporters of the Pact claim that controlling deficits is the best route towards monitoring debts. However the danger frequently lies outside the scope of the public accounts. Controversies about a few tenths of percentage points of deficit are dwarfed by large off-balance sheet liabilities, especially but not exclusively corresponding to pay-as-you-go pension system. Although the ministers and the European Commission have signalled an intention to address the issue, for all practical purposes the Stability pact works as an incentive to focus on the trivial and to overlook the crucial. For example, it would stand in the way of

* The writer is a professor at Université Paris-Dauphine and a member of the European Commission president's Group of Economic Analysis.

government that makes short term concessions to build consensus on long term pension reform, even though this would improve the sustainability of public finance.

Policymakers should thus consider reforms. The delicate balance they must achieve is to address the flaws in the Pact while keeping intact the commitment it embodies. A practical way out could be to offer member states the option to subscribe to a “Debt Sustainability Pact”. Participating countries would have (i) to publish comprehensive public finance accounts according to improved EU accounting standards that allow to assess off-balance sheet liabilities; (ii) to keep their debt (Maastricht definition) below a certain threshold, say, 50% of GDP; and (iii) to set a five years target for the debt ratio, that would serve as a benchmark for assessing their budgetary policy. Member states satisfying these conditions would automatically qualify in the no-excessive deficit procedure. Failure to comply with any of them would automatically activate the standard excessive deficit procedure and, if relevant, trigger sanctions.

Such a scheme would preserve the common commitment to discipline but provide flexibility to adapt to the dispersion of public finance situations. It would reward responsible long term behaviour with short term autonomy. And it would give an incentive to member states to reduce debt and reform accounting procedures in order to qualify as ‘tier 1’ countries. This is why the EU should build on its achievements to consider what should come next, instead of treating a mere practical arrangement as the Tables of the Law.