

Europe's Instability Pact

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Last month Pedro Solbes, the European Union's commissioner for economic and monetary affairs, presented the Council of Economics and Finance Ministers a desperate last-ditch plan to save Europe's Stability and Growth Pact. Mr. Solbes' proposal strikes out in the right direction, but it does not go far enough.

In its short life, the Pact has achieved many good things. It has reminded governments to avoid policies that threaten financial stability. It has signaled that the euro area takes seriously its commitment to a sound currency. It has given the European Commission the opportunity to remind governments that the greying of populations implies the need to start saving more now.

But it is important to recognize that the Pact is now on life support. France and Italy have announced the intention of running larger deficits than those to which they committed previously. Their defense is that their detailed knowledge of their economies provides a better guide to what deficits are appropriate to the circumstances than the ad hoc numerical guidelines followed by the European Commission. This argument may be nothing but rhetorical cover for politically motivated tax cuts. But given the absence of a firm analytical foundation for the Pact's numerical targets and ceilings, the Commission, in attempting to counter the machinations of national governments, has not a leg to stand on.

Mr. Solbes therefore proposes a more flexible interpretation of the Pact. Under his proposal, member states that stick to a medium term objective of balancing their structural budgets – meaning their budgets adjusted for the effect of the business cycle -- will be allowed to

run larger deficits in recessions. Countries with low state pension liabilities and low public debts will also be cut additional slack, at the Commission's discretion.

This is a step in the direction of economic rationality and consistency. If this new interpretation is applied even-handedly, with waivers for countries that stick to structural budget balance and sanctions for the rest, the credibility of the Pact would be restored.

But herein lies the rub. Precisely what Europe hasn't been able to achieve is even-handed enforcement of the Pact. Earlier this year, the European Commission's letters of warning to Germany and Portugal about their failure to bring their deficits toward structural balance were effectively rebuffed. Now we learn that Portugal's 2001 deficit was even larger than estimated previously. France was able to wriggle out of sanctions, despite the fact that its projected deficit of 2.6 per cent of GDP far exceeds the 1.4 per cent on which the 2002 budget was originally calculated – and this even before President Chirac's promised tax cuts. Italy, having announced that it is aiming for a deficit of 0.8 per cent in 2003, and having thereby abandoned its commitment to bring its budget near to balance, is heatedly denying that the overage is a problem. It seems likely to escape penalties as well. Tiny Portugal may be sanctioned, when European officials return from their August holiday, not because its sins are especially grave but simply because it has less political clout.

Two lessons follow. First, the bloodhounds in Brussels will always be one step behind the greyhounds in national capitals, who know better where the fiscal bodies are buried. A procedure that relies on governments to audit their own accounts and on the Commission for oversight will never succeed in ferreting out the true situation before it is too late.

Second, a procedure in which governments are asked to accept the decisions of the

Commission will never be free of political interference. Large countries like Germany and France will always be able to use their leverage to veto an adverse decision. Small countries like Portugal and Ireland will therefore become the targets of a process that officials wish to show has teeth. As a result, the Pact will not be seen as either fair or credible.

The solution is not to abandon the Pact but to reform it. The rationale for the Pact is that deficits today may imply deficits tomorrow, and that chronic deficits will force the ECB to provide an inflationary debt bailout. But not all deficits are equally chronic. Persistent deficits are a danger only where countries fail to reform their fiscal institutions. Countries with large unfunded pension liabilities, like Greece and Spain, will almost certainly have deficits down the road. Where workers are allowed to draw unemployment and disability benefits indefinitely, deficits today signal deficits tomorrow. Countries that have not completed privatizing public enterprise, like France, are similarly more likely to find future fiscal skeletons in the closet. Where revenue-sharing systems that allow states and municipalities to spend today and be bailed out tomorrow, central governments will almost certainly suffer chronic deficits.

Thus, the Pact should focus not on fiscal numbers, which are arbitrary and easily cooked, but on fiscal institutions. The Council of Ministers should take Mr. Solbes proposal one step further. It agree on an index of institutional reform with, say, a point each for privatization, pension reform, unemployment insurance reform, and revenue sharing reform. It should then authorize the Commission to grade countries accordingly. Those receiving four points would be exempt from the Stability Pact's guidelines, since there is no reason to expect that they will be prone to chronic deficits. The others, in contrast, would still be subject to warnings, sanctions, and fines.

By keying on fiscal institutions, this revised Pact will focus on chronic deficits, which are the essential problem. By focusing on institutional reform, which is readily observed, rather than on budget estimates, which are easily obscured, the revised Pact will be more credible. By giving governments the right to define the index of institutional reform and limiting the Commission's discretion, the process will be politically legitimate. But, by taking veto power out of ministers' hands, it will be free from political interference.

Above all, a reformed Pact that focuses on institutions, rather than arbitrary and easily manipulated fiscal numbers, would treat European governments as grownups. It would recognize them as capable of deciding their own fiscal policies, without interference from the European Commission or their EU partners, so long as they are undertake essential institutional reforms.

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