A Dose of Structural Reform for the Stability Pact

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Structural reform is topic number one on Germany's economic agenda. The country needs far-reaching reform of its pension system, its labor market institutions, and its federal fiscal arrangements to boost its anemic rate of growth. Chancellor Schroder has laid down the gauntlet, and one can only hope that the parties will take it up.

The Chancellor's dilemma is that structural reform may compound Germany's problem with the Stability and Growth Pact. In the long run, to be sure, structural reform will mean faster growth, more tax revenues, and a stronger budget. Unfortunately, the short-run implications will be less favorable. Older workers, anticipating lower pension incomes, will spend less. Unemployed workers, anticipating the curtailment of their benefits, will spend less. As demand falls, growth will slow, forcing the government to raise taxes. That will depress growth even more, further aggravating the budget deficit.

The Stability Pact recognizes none of these points. Its ostensible purpose is to prevent governments from running chronic deficits and accumulating unsustainable debts. Yet its 3 per cent reference value does nothing to distinguish chronic from transitory deficits. A budget deficit, even one above 3 per cent, is part of the solution when it results from a temporary growth slowdown, since it works to stabilize the level of spending. It is only worrisome if allowed to persist year after year.

The solution is to subject the Stability Pact to a dose of the same structural reform prescribed for the German economy. We know a lot about what structures lead countries to run chronic deficits. Where central governments raise the revenues but subcentral governments do the spending, chronic deficits tend to result, since the states and municipalities are allowed to spend now and to go running to the central government for financial assistance later. In contrast, where each fiscal jurisdiction has its own source of revenues, which are proportional to its spending obligations, chronic deficits are less. Deficits tend to be less where pension systems have been reformed, so that there will be no spending explosion in the future. They tend to be less where labor markets and unemployment entitlements have been reformed, so that unemployment is not a constant drain on the budget.

Hence, countries that reform their budgeting institutions, their pension systems, and their labor markets can be trusted to run their own fiscal policies. Their deficits are not indicative of chronic overspending. They just reflect the fact that the economy is in a temporary slowdown, revenues have fallen off, and automatic fiscal stabilizers have kicked in.

In countries with poorly-designed and ill-functioning fiscal institutions, in contrast, deficits are likely to be chronic. This year's budget deficit is rightly seen as a warning of future problems. There, clear numerical limits on admissible deficit spending are needed to protect against unsustainable debts.

Hence, the EU should agree on an index of institutional reform with a point each for pension reform, labor market and unemployment insurance reform, and revenue sharing reform. Countries receiving 3 points would be exempt from the Stability Pact's numerical guidelines, since there is no reason to expect that they will be prone to chronic deficits. In contrast, the others, because their weak institutions make them susceptible to chronic deficits, should still be subject to the pact's warnings, sanctions, and fines.

Some will dismiss these proposals as naive. An index of fiscal institutions would be less transparent, less easily monitored, and therefore less credible, they will warn, than a 3 per cent reference value for the consolidated budget deficit. But we should not overlook the ability of governments to fudge their fiscal accounts. Recall Italy's budget deficit in 1997, or recent revisions of the Portuguese public accounts. My institutional indices may be disputable, in other words, but what about your deficit forecasts?

Other will object that knowledge of what fiscal institutions help to prevent chronic deficits may change over time. But permitting the politicians responsible for the Stability Pact to alter the index of budgetary institutions would open the door to lobbying and backroom deal-making. This suggests creating an independent committee of fiscal policy experts to define the index. Countries would not tolerate having a committee of the EU prescribe the structure of their fiscal institutions, of course, but the committee I have in mind could not force a country to modify its institutions. If countries prefer institutional arrangements that have proven to be conducive to chronic deficits in other times and places, they would be free to maintain them. But they would then be subject to the 3 per cent reference values of the Stability Pact.

The accompanying table shows which EU countries would currently be subject to the numerical ceilings of the Stability Pact under my proposal and which ones would be exempt. Belgium, Ireland, Luxembourg, Austria, and the UK would be exempt. Other member states, in contrast, would still be subject to existing EU procedures. In particular, the four large countries of the continent – including Germany – would still be subject to the Pact's warnings, non-interest-bearing deposits, and fines.

The real advantage of this proposal is that it would reinforce the pressure that already exists for structural reform. The same reforms that would render the German economy more flexible and boost its sustainable rate of growth would also earn it an exemption from the Stability Pact. It could then use fiscal policy to stabilize demand while the economy was still adjusting to the effects of structural reform. The desire to abide by the rules of Europe's Stability Pact and the need to fix the flaws in the German economy would no longer conflict. Structural reform would become the solution to both problems.

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Table 2. Who Would Be Exempt from Sanctions and Fines?
(3 point indicates exemption)

Country	Criterion		
	Limited Future Pension Liabilities	Appropriate Fiscal Institutions	Adequate Labor Market Reforms
Belgium	1	1	1
Denmark	0	0	1
Germany	1	0	0
Greece	1	1	0
Spain	1	0	0
France	0	1	0
Ireland	1	1	1
Italy	1	1	0
Luxembourg	1	1	1
Netherlands	0	0	1
Austria	1	1	1
Portugal	0	0	0
Finland	1	0	1
Sweden	1	0	1
UK	1	1	1