

THE STABILITY AND GROWTH PACT IN NEED OF REFORM

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1. Introduction

The Stability and Growth Pact is under increasing pressure. Two issues arise concerning the Stability and Growth Pact (SGP). The first one is related to the long-term objective, which is implicit in the Pact. The second issue has to do with the degree of flexibility that the SGP provides. The second issue has received most of the attention recently, although the first one is of equal importance. We discuss these two issues in this paper.

2. The long-term objective

There is an increasing consensus that the sustainability of government debt levels should be the first criterion to judge the appropriateness of the fiscal policy stance of countries¹. Policies should be geared towards the objective of reaching a debt level that is sustainable in the long run. Essential in this concept is that debt levels should not be such as to put excessive burdens on future governments, which would give them an incentive to default on the debt they have inherited.

Although this is true for all countries in the world, it has a special significance for countries forming a monetary union. The risk that one of the member countries of the union may be on an unsustainable debt path is a matter of common concern for all the other members. The reason is that in a monetary union a debt default of one member state would affect the stability of the whole union. As a result, the members of a monetary union will find it in their interest to control each other's budgetary behaviour. This common concern for maintaining sustainability of national debt levels in a monetary union has led to the budgetary rules in the Maastricht Treaty and later to the Stability and Growth Pact (SGP).

The Maastricht Treaty has given a practical meaning to sustainability. It defined the sustainable debt level to be 60% of GDP. The corresponding budget deficit consistent with this target debt ratio was put at 3% of GDP. It is well known that the 3% deficit

¹ See Coeuré and Pisani-Ferry(2003) and Wyplosz(2002) who stress this point.

norm will indeed ensure that the 60% debt ratio can be kept constant provided the nominal growth of GDP happens to be 5%².

It has been noted by many economists that these numbers are quite arbitrary (Buiter, at al.(1993)). This is indeed the case. It is quite surprising that European countries with a long tradition of rational thinking have found it necessary to subject themselves to arbitrary numbers whose scientific basis is lacking. We will not pursue this issue further here, however. The quality of the Maastricht numerology is that it puts some concrete targets for debts and deficits, which are broadly consistent. In addition, the Maastricht numerology has an important implication, which thanks to the SGP, is now largely forgotten by the European policy makers. This is that a country with a debt of 60% and a deficit of 3% is not in danger of finding itself on an unsustainable debt path, provided that the medium run nominal growth of GDP is close to 5%³.

Things have changed since the Maastricht Treaty. The Stability Pact redefined the steady state target that countries should aim at. By insisting that governments should balance the budget over the medium run, the steady state target for the debt ratio was lowered from 60% to 0%⁴. A formidable change in objectives, that went almost unnoticed at the time the stability pact was agreed upon.

The implication of this change in objective is shown in figure 1a. We present the hypothetical evolution of the debt ratios within Euroland assuming that the member countries abide by the pact (a heroic assumption), and assuming that nominal GDP increases by 5% a year. We see that the application of the GSP leads to a situation in which the debt ratio of all the member countries (except three, Belgium, Greece and Italy) drops below 20% during the next 20 years. The conclusion is not much affected by assuming a nominal yearly growth rate of GDP of 4%. In that case it takes 25 years for the same countries to lower their Debt/GDP ratio to less than 20%. Thus, if countries abide by the pact they will quickly move their debt to GDP ratios in the

² This follows from the well-known steady state relationship between deficit and debt ratios for given nominal growth rate of GDP, i.e. $d = b/y$, where d =the deficit as % of GDP, b =the debt as % of GDP and y =the nominal growth rate of GDP.

³ I take the view that this 5% nominal growth condition will be satisfied in the medium run (2.5% real growth, and assuming that the ECB will stop aiming at an inflation rate of at most 2% and will do what other reasonable central banks are doing these days, aiming at an inflation rate between 2 and 3%).

⁴ This follows from the same steady state relationship noted in footnote 2. As long as the growth rate of nominal GDP is higher than 0, a balanced budget requirement will move the debt ratio towards 0.

neighbourhood of zero. The question arises whether good economic arguments can be found to force countries onto such a path.

Figure 1a:

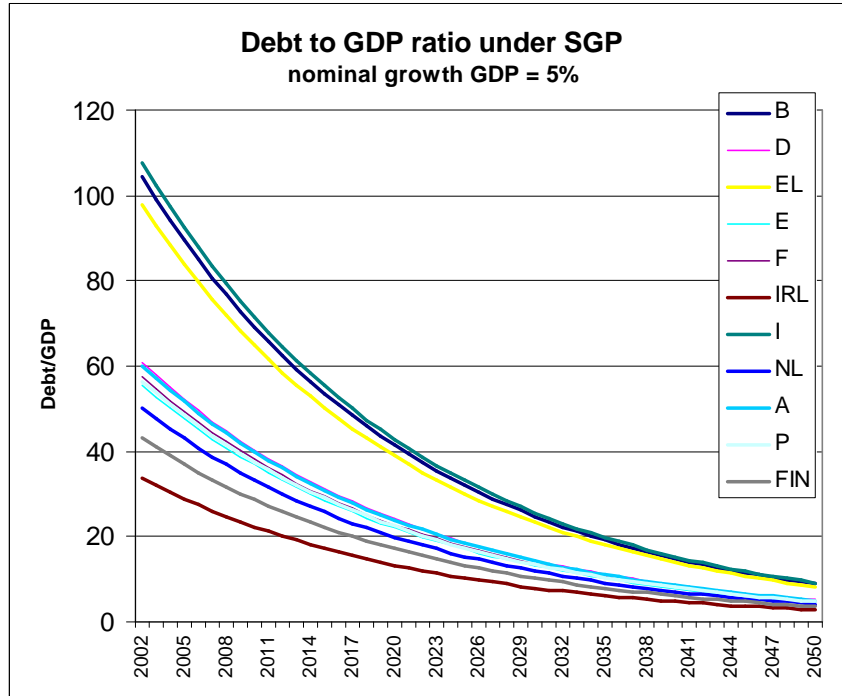
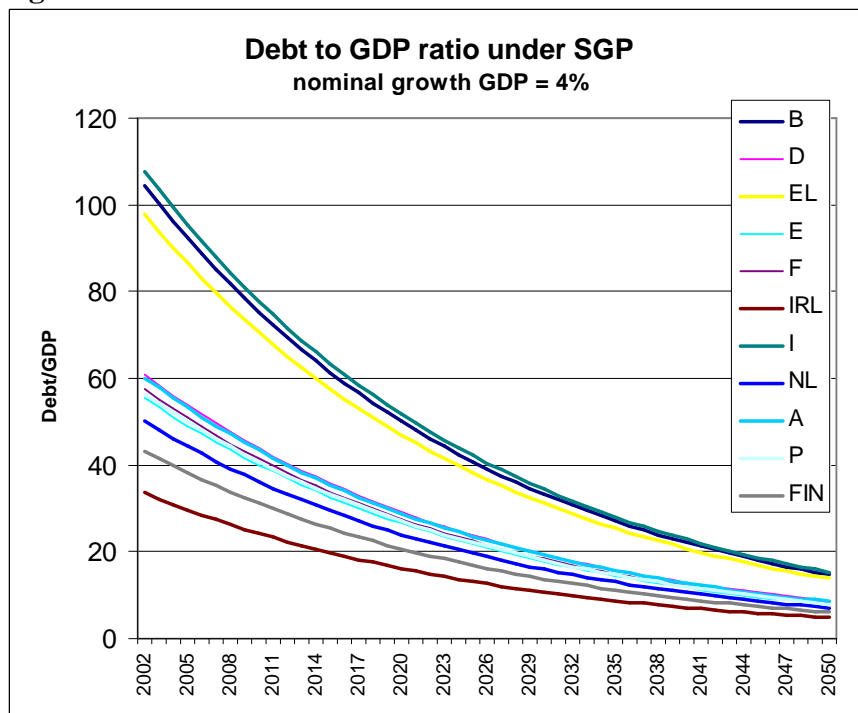


Figure 1b:



It can be argued that the introduction of the GSP balanced budget rule made sense as a *temporary* strategy for highly indebted countries like Belgium, Greece and Italy.

From figure 1a and b it can be seen that if these three countries abide by the rule they will be able to reduce their excessive debt levels quickly to reach the Maastricht 60% norm around 2015. The issue, however, is whether this balanced budget rule should be imposed as a *permanent* strategy forcing these countries to bring their debt ratios to zero in the long run. Similarly, and more importantly, the issue arises whether the other EU-countries, which according to the Maastricht sustainability criterion had no problems of excessive debt levels, should also be forced to move onto a path that should bring their debt ratios to 0.

It is generally accepted that firms can have a debt, provided it is sustainable. This is so because private companies make productive investments that will profit present *and* future shareholders. It is therefore reasonable to let future shareholders share in the burden of the debt. A same argument holds for governments. Governments, which invest in physical and human capital, do raise the productive capacity of nations, benefiting present and future generations. It is therefore quite reasonable to let not only present but also future taxpayers share in the cost of these investments. Issuing debt is the way to achieve this inter-temporal cost sharing.

It is therefore difficult to understand the insistence of the GSP that EU-governments should not issue new debt and that they should drive their debt ratios to zero. One possible interpretation of this insistence is based on a fashionable contemporary cynicism about governments, which is that these are incapable of making productive investments that will benefit future generations. As a result, future taxpayers will not inherit anything useful from today's public investments, and they should not be asked to contribute.

The GSP-ban on the issue of new government debt is likely to have a negative effect on long-term economic growth in the EU. This can be explained as follows. The requirement to bring the debt ratio to zero gives strong political incentives to reduce government investment. The reason is that the requirement that all new investments should be financed by current taxation, while a large part of the benefits of these investments will be reaped by future governments, gives an incentive to governments today to reduce these investments and only spend on items that benefit the present voters. Thus the GSP is likely to lead to lower government investments. There is

strong empirical evidence that investment in infrastructure and in human capital are key to boost long term economic growth. By discouraging this kind of investment the Growth and Stability Pact will contribute to a low growth environment in the Eurozone.

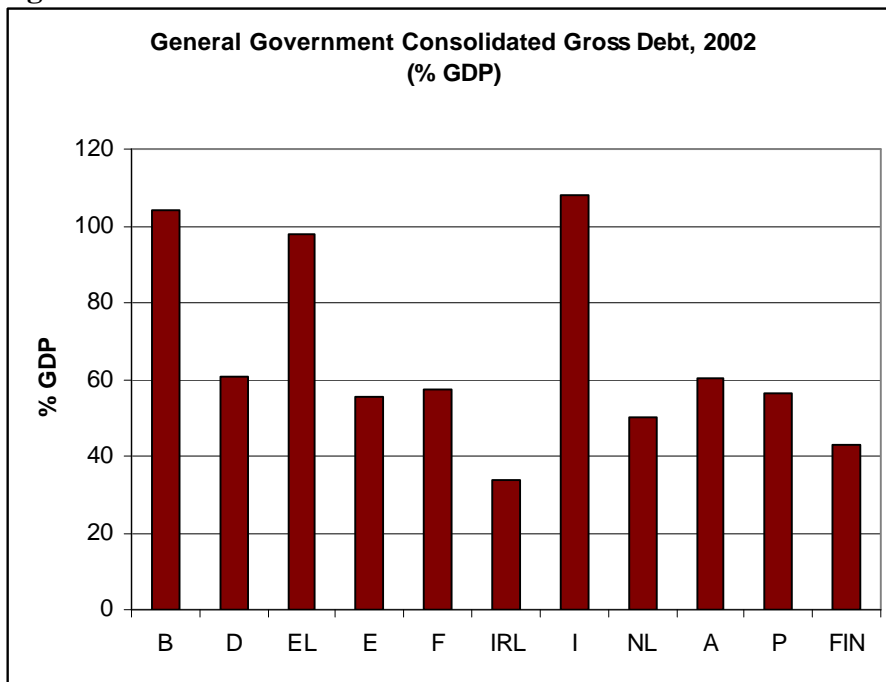
The lack of a sound economic rationale of the requirement to reduce the debt ratio to zero will make the GSP politically unsustainable. At some point, when the current obsession with balanced budgets will have waned, governments will wake up and ask themselves the question of why they continue to use rules that have no rational foundation. The closer their debt ratio approaches zero the stronger this questioning of the GSP rules will become. Thus these rules are bound to be abandoned.

It is time to return to the spirit of the Maastricht Treaty. This is that countries should stabilize their debt ratio in the neighbourhood of 60%⁵. As can be seen from figure 2 all euro zone countries (with the exception of Belgium, Greece and Italy) have a debt ratio of 60% or less. Applying the Maastricht sustainability criterion today, implies that a 3% budget deficit is approximately appropriate for most countries of the euro zone, assuming that the nominal growth rate will be close to 5% as a steady state trend. We show this in figure 3 for France, Germany and Portugal, three countries that have been singled out by the procedures set out in the SGP. If these countries keep their budget deficits equal to 3%, then their debt ratio stabilizes at 60%⁶. It is true that two of these countries Germany and Portugal actually exceeded the 3% deficit norm in 2002. We come back to issues related to fluctuations around the deficit criterion.

⁵ We return to the issue of whether the 60% debt norm is the right one for all countries.

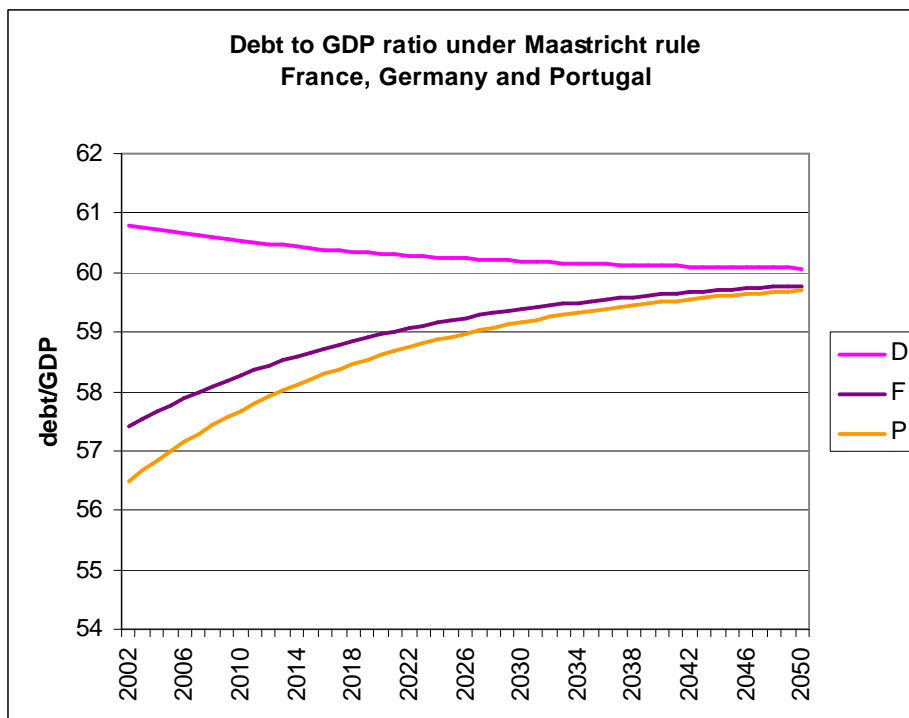
⁶ %. Of course this is true for all countries under the same nominal growth assumptions. The point is that with a deficit of 3% these countries will see little movements in their debt ratios. It is therefore difficult to see how they can be said to be on an unsustainable debt path.

Figure 2



Source: European Commission, European Economy, Statistical Annex, Spring 2002

Figure 3



3. How much flexibility

The defenders of the stability pact argue that if countries keep a balanced budget over the business cycle, they will have enough flexibility during a recession allowing them

to let the budget deficit increase up to 3%. This should be sufficient for most countries to follow an anti-cyclical budgetary policy during most recessions (see e.g. Buti and Sapir(2000)).

Thus the stability pact instructs countries that they should be on a declining debt path before they can hope to exploit the flexibility of the pact. The result of this idea is that the countries that are not on such a path, are forced to reduce their debt to GDP ratio during the present economic slowdown. We argued that there is no justification for most of the euro zone countries to follow such a strategy in normal times. There is even less justification for such a policy prescription during a recession.

The main reason is that during a recession the debt to GDP ratio of modern nations has a tendency to increase because of the built-in stabilizing properties of government budgets. This feature constitutes one of the great advances in economic policies, and helps explain why during the least 50 years European nations have been spared the deep depressions of earlier eras.

Official thinking about fiscal policy has gone back half a century to pre-Keynesian analysis of government budgets. One of the great ideas in Keynesian thinking is that there is a savings paradox: When everybody attempts to increase savings at the same time there will not be much additional saving because of the decline in income. That's when the government should step in and start dissaving. The only exception to this rule is when it moves the government debt into an unsustainable path. This is not the case with most Eurozone countries today.

4. Alternative debt criteria

In the previous analysis we have taken the view that the 60% debt ratio as defined by the Maastricht criterion is the appropriate target to shoot at. One could have quarrels with this. There is indeed no economic theory that can be invoked to decide that 60% is optimal for the euro zone as a whole, let alone for all individual members. In fact there is much to be said for applying different debt targets for different countries. For example, some countries have well-funded pension systems reducing the future pension liabilities of their governments. These countries can then afford larger debt ratios than countries with unfunded pension systems.

Let us then assume different target debt ratios. One can then easily compute the corresponding deficit levels that are required to stabilize the debt ratio at the target levels⁷. We show these in table 1.

Table 1

	Required deficits (% GDP) to reach different target debt ratios (nominal growth of GDP = 5%)					
target debt ratio	10%	20%	30%	40%	50%	60%
required deficit	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%

	Required deficits (% GDP) to reach different target debt ratios (nominal growth of GDP = 4%)					
target debt ratio	10%	20%	30%	40%	50%	60%
required deficit	0.4%	0.8%	1.2%	1.6%	2.0%	2.4%

The important insight obtained from this analysis is the following. If we have reasons to believe that in some countries the target debt ratio should be lower than 60% we should make the exercise and try to identify what this target debt ratio is. Suppose, for example, that we conclude that the right debt ratio for Germany is 40%, then this implies that the steady state deficit that German should aim at over the cycle is 2% (assuming a long run 5% nominal growth rate) or 1.6% (assuming a long run 4% nominal growth rate). Thus even under this more restrictive debt target, there is still no reason to impose a balanced budget over the cycle as the SGP does. One can also reasonably argue that the present deficit overshoot in Germany should be tolerated as a temporary departure of the 1.6 to 2% deficit norm that we assume here as an example.

5. A proposal

We argued that it is time to return to the Maastricht spirit (not its letter) to reform the Stability Pact. The ingredients of such a reformed Stability Pact could be the following⁸.

⁷ This computation is done using the same formula as spelled out in footnote 1.

First, all member countries agree that the debt ratio should not exceed 60%. In fact, when they signed the Treaty they agreed to apply this rule.

Second, (and this is the novelty), each government defines a target debt ratio that it considers appropriate, given its specific conditions. Thus, a country with large unfunded pension liabilities may choose a significantly lower target debt ratio (e.g. 40%). Once this national target debt ratio is defined it is announced to the other member states. Each government is then committed to keep the debt ratio at the target level over the business cycle.

Third, short-term deviations from this national target are possible to accommodate for business cycle fluctuations. This implies that if during a recession the debt ratio is overshot; it should decline during the boom, so as to keep the debt ratio on its long run target path.

Since the debt ratios are slow moving variables it will remain important to monitor the budget deficits, which can be changed quicker. This can easily be done since there is a correspondence between the sustainable debt ratios and the budget deficits that bring us to these sustainable debt levels. Suppose for example that a country has declared its national target for the debt ratio to be 40%. In this case the steady state budget deficit consistent with this target is 2% (with a nominal growth rate of 5%). When this country departs from this target, this will show up in budget deficits that systematically exceed 2%. Corrective action requiring reductions in the deficits can then be imposed.

Once countries are close to their national debt target, the system can have sufficient flexibility to allow for automatic stabilizers to work. Thus our country with a debt target of 40% can allow its deficit to exceed 2% for a number of years, provided it allows the deficit to decline below 2% during booms. Without such symmetry the debt ratio cannot be stabilized at 40%. The advantage of announcing a debt target is that it gives a stronger signal that the rule will be applied symmetrically.

⁸ See Coeuré and Pisani-Ferry(2003) and Wyplosz(2002) for similar proposals. There are many other aspects to the reform of the stability pact. Some have to do with the improvement of the budgetary processes in the member states. This has been analysed by von Hagen, among others (see von Hagen, et al. (2002)). We do not pursue this matter here.

The symmetry is often politically difficult. The same, however, can be said of the GSP, which requires a similar symmetry, while at the same time forcing countries on a debt path that is *politically* unsustainable in the long run.

From the preceding analysis it will also be clear that the 3% deficit ceiling cannot be maintained in our proposal. To make this clear, suppose again a country, which has declared a 40% debt to GDP target, and assume a nominal growth rate of 5%. As we have seen, in this case the steady state deficit is 2%. This means that during a recession this country will almost certainly exceed the 3% deficit ceiling. Put differently with a steady state deficit of 2% and a deficit ceiling of 3% the flexibility provided by the system would only be 1%. This is certainly too low to allow the automatic stabilizers to do their work during a recession (see Brunila, et al. (2003), Buti and Sapir(2002)).

There are many issues concerning the enforcement of our proposal. We do not pursue this matter here. Such an enforcement could be done within the present “excess deficit procedure” provided in the Treaty, or one could go much farther and create a new independent watchdog to monitor the countries’ debt ratios⁹.

5. Conclusion

The Stability and Growth Pact has gone much further than the Maastricht Treaty in forcing a budgetary straightjacket on EU-member countries. The medium run balanced budget requirement of the SGP forces countries to stop issuing new debt and pushes them on a path whereby the debt ratio is driven to zero. We argued that there is no economic justification for such a requirement, except as a temporary strategy for the highly indebted countries (Belgium, Greece and Italy). In addition, the GSP strategy is politically unsustainable. When countries’ debt ratios come closer to zero, the political pressure to abandon this strategy, which has no economic justification, will be overwhelming.

We also argued that if we take the 60% debt criterion defined in the Maastricht Treaty as a sustainable debt ratio to which countries can choose to converge, the present budgetary situations of France, Germany and Portugal are not troublesome, and these countries should not be forced to increase taxes and reduce spending in the midst of

⁹ For proposals in this vein, see von Hagen, et al. (2003) and Wyplosz(2002).

an economic slowdown. Alternatively, if we have reasons to believe that the 60% norm is too high for these countries, then we have to identify the debt ratio that is sustainable for these countries. We have argued that even in the latter case the policy prescriptions will be far removed from the SGP.

We formulated an alternative stability pact based on the idea that the objective of the pact should be to stabilize the debt ratios. This idea has been defended by many economists recently. We argued that it would be desirable allow countries to choose their own national debt targets, provided it is below 60%. A reformulation of the SGP in terms of debt levels allows to better define the long term targets to which countries should converge. At the same time it will be easier to implement a symmetric budget deficit rule around the target levels.

It should be stressed that a reform of the stability pact that focuses on targets for the debt ratios is inconsistent with the maintenance of the 3% budget deficit ceiling. This is so because when countries target a positive debt ratio, the ensuing equilibrium budget deficit will also be a positive number. As a result, the flexibility of the system which can be measured by the difference between the deficit ceiling and the equilibrium deficit, is reduced. We used the example of a country which targets a debt ratio of 40%. Assuming a nominal growth rate of 5%, this country can have an equilibrium budget deficit of 2%. Such a well behaved country would almost certainly exceed the deficit ceiling of 3% with every recession.

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