The Stability and Growth Pact: Problems and a Possible Solution

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1. Executive Summary

In this note, I describe why we need a European fiscal framework. I specify what it means for a government's fiscal policy to be sustainable. I argue that while the current European fiscal framework is likely to promote sustainable fiscal policies, if it is enforced, it is also apt to force countries to follow suboptimal fiscal policies. I explain why there is no fiscal rule that will provide a satisfactory fiscal framework. Finally, I describe an alternative: a fiscal Sustainability Council. This idea was developed by Fatás, von Hagen, Hughes-Hallet, Sibert and Strauch [1]

2. Why do we need a European fiscal framework? Why Do Countries Run too Large Deficits?

Unsustainable fiscal policies by member states might threaten the area-wide financial system or destabilise the common currency by putting pressure on the common central bank to provide a bailout. National governments may not take this common cost into consideration and may be tempted to run excessively large deficits. Some reasons for this are as follows. First, governments may be tempted to spend too much and future generations are underrepresented in the political decision-making process.[1] Thus, governments may be tempted to borrow to finance their excessive spending. Second, different political parties may disagree on the composition of government spending – say, one party prefers military spending and the other wants more funding on social programmes. Then the party that is in power may attempt to constrain a successor government's ability to spend by financing its spending on the goods of its choice by borrowing. Third, there is a political business cycle story. Suppose politicians differ in how competent they are at using tax revenue to provide public goods and their competency is known only to themselves. Then incumbent politicians may lower taxes prior to an election to signal that they do not need as much tax revenue as less competent governments do to be able to provide the same level of public spending. Fourth, suppose unforseen economic circumstances produce a deficit and reducing this deficit requires compromise between different groups. Then deficit reduction may be held up as the different groups use delay to signal that the costs to them of reform are particulary high, and thus they must be compensated. In each of these four stories, the government prefers to keep the country solvent. However, it is possible that by increasing current deficits the government may increase the risk of future insolvency.

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[1] One reason for this is that special-interest groups that want increased spending in a particular area tend to be better organised than the larger groups that oppose them. See Fatás, et al [1] for a detailed description of factors leading to excessively high budget deficits.

3. What is a Sustainable Fiscal Policy?

For a government's fiscal policy to be sustainable, it must satisfy two conditions. First, each period the government must satisfy its within-period budget constraint by financing any fiscal shortfall by borrowing. Its current spending on goods and services plus the cost of servicing its current debt must equal its current tax revenues plus the issuance of new debt. The primary deficit is defined as spending on goods and services minus tax revenues; hence, another way of saying this is that each period the government's primary deficit plus the cost of servicing its current debt must equal its issuance of new debt. The second condition is that the government cannot run a Ponzi scheme where debt grows forever in an explosive fashion while the government satisfies its within-period budget constraint by issuing ever-increasing amounts of new debt to pay off the old plus the interest. It can be shown that these two conditions imply that sustainability requires that the present discounted value of the goverment's path of primary deficits plus the value of its initial stock of debt must equal zero; that is, the discounted present value of its revenues must equal the discounted present value of its expenses.[2]

The above condition implies a number of things that are important to take into account when designing a fiscal framework. There are many different paths of primary budget balances that are consistent with sustainability. Running sizable primary deficits for a long period of time may be consistent with sustainability if these deficits are later balanced by sufficiently large surpluses. A path of primary deficits that might be unsustainable for one country may be sustainable for another, if their future growth or initial debt stocks are sufficiently different.

There are a number of practical problems associated with assessing whether a particular country's current deficit-to-GDP ratio is consistent with sustainability. It requires projecting nominal interest rates and nominal GDP growth. Measuring the true financial position of the government is difficult due to data collection and accounting difficulties. The size of future deficits depends on the composition of current public spending in a way that is hard to assess. The stituation is complicated by the existence of business cycles; it is difficult to predict how much of a current economic shock is transitory and how much is permanent.

4. The Current European Fiscal Framework Leads to Suboptimal Fiscal Policy

In its current form, the conditions of the current European fiscal framework – if strictly adhered to – are likely to result in sustainable fiscal policies. However, there are many paths of primary deficits that are consistent with sustainability, and some of these paths do not satisfy the deficit criteria of the current framework. As the EU fiscal framework does not regulate the level of government spending, I will assume that a government's spending is given. I then ask the following. As long as the government follows a sustainable fiscal plan, does it matter which sustainable plan it follows? That is, does the timing of taxes matter for social welfare? If it matters, do plans that satisfy the deficit criteria yield lower social welfare then plans that do not?

4.1. The timing of taxes. If government spending is fixed, does the timing of taxes matter? According to a modern textbook paradigm it does not. In this framework, it

[2] Mathematically, this implies that $\sum_{t=1}^{\infty} d_t \prod_{s=1}^{t}(1+\gamma_s)/(1+i_s) + b_0 = 0$, where d_t, γ_t, and i_t are the primary deficit-to-GDP ratio, the nominal growth rate of GPD, and the nonimal interest rate, respectively, at t and b_0 is the initial debt-to-GDP ratio.

is supposed that a country is inhabited by infinite-lived households who face no credit constraints. The government finances its spending by imposing lump-sum costless taxes or by borrowing. The government remains solvent and the household expects this. The government's sustainability constraint, discussed in Section 3, depends only the present discounted value of its tax obligations and not on their timing

The household has its own sustainability constraint: the present discounted value of its consumption must equal the present discounted value of its income plus its initial wealth minus the present discounted value of its tax obligations. Thus, the household also cares solely about the present discounted value of its tax obligations and not on their timing. To see this more concretely, imagine that the government were to cut taxes in the current period, borrow the short fall, and raise taxes next period to pay off the borrowing plus interest. The household knows that the tax cut leaves it no better off. If it invests the amount of the tax cut, the investment will produce just enough income to pay off the higher taxes next period.

The above argument depends on three things: the taxes are lump-sum and costless, the household can borrow and lend as much as it wants (subject to being able to satisfy its sustainability constraint), the household lives forever. Suppose that instead it is costly to administer and comply with the tax code and that these costs are increasing at an increasing rate in the level of tax revenue. Then the total costs associated with taxes are minimised if the taxes are smoothed over time. If the household is credit constrained, then in some periods consumers may be unable to borrow enough to smooth their consumption as much as they would like. High or low taxes in these periods can worsen or improve matters. If households are finite-lived, then a current tax cut may benefit current households at the expense of future households.

4.2. Balancing the budget in the medium term may rule out optimally smoothing consumption. Imagine a scenario where there are no business cycles, nominal income growth and the nominal interest rate are both strictly positive and constant over time, and the government's desired expenditures (net of interest payments) are a constant share of GDP. The government can finance its expenditures by borrowing or by taxation. I assume that the timing of taxes matters because tax collection is costly, as described in Section 4.1. If society prefers smooth to variable consumption over time, then the government should smooth taxes over time. Thus, it is optimal for the government to have a constant primary budget balance, as a share of GDP, over time.[3] This condition and the sustainability condition described in Section 3 can be solved to yield the government's optimal primary budget balance.[4]

The Stability and Growth Pact requires budgets to be close to balance or in surplus over the medium term. With no business cycles in this example, I interpret this restriction to mean here that the government should not run a (conventional) budget deficit. Unfortunately, the above optimal fiscal policy, with its constant primary budget balance, is not consistent with this. To see this, note that if the government always balances its budget (including interest payments), then it never has to borrow and its stock of debt remains constant. Having a constant debt stock implies that there will be constant positive interest payments and the government must always run a primary surplus to balance

[3] I make the reasonable assumption that that the actions of a single EU government have negligible effect on the risk-free world interest rate.

[4] The government should set a primary deficit to GDP ratio of $(\gamma - i)\, b_0 / (1 + \gamma)$, where γ is nominal income growth, i is the nominal interest rate and b_0 is government debt as a share of GDP.

its budget. Positive nominal GDP growth implies that the ratio of interest payments to GDP falls over time. Thus, the primary surplus, as a share of GDP, falls over time to leave the budget balanced. Thus, satisfying both the sustainability constraint and the zero-deficit rule implies that the government must run a sequence of decreasing primary surpluses (as a share of GDP) over time.[5]

4.3. A three-percent deficit limit may rule out optimally offsetting business cycle fluctuations. Suppose that a country is subject to cyclical shocks. The timing of taxes matters because there are costs associated with tax collection and because households are credit constrained and unable to smooth their consumption to the degree that they would if they could borrow as much as they wanted. Then the government faces a tradeoff between further smoothing consumption, which it can do by increasing taxes in good periods and decreasing them in bad periods, and minimizing the costs of taxes by smoothing them. It should dampen, although not entirely smooth away the effect of the shocks. A three-percent upper bound on its admissible primary deficit may be too restrictive to permit this.

4.4. Deficit limits may rule out socially desirable government investment. Consider a country where current government investment spending is desirable. This spending might be thought of as spending on intrastructure in the transition economies or the United Kingdom, or it might be the financing of labor-market reforms in countries such as Germany and France. If the government undertook this expenditure and was forced to balance its budget, there would be an large current tax bill. If there are costs associated with tax collection, this is not efficient; it would be better to spread the tax bill out over time. It may not be equitable either. As both current and future households benefit from the spending, it is not obvious that current households should bear the entire cost. Thus, both equity and efficiency may imply a sizable current deficit.

5. WHAT IS THE ALTERNATIVE?

5.1. There is no good rule. Whether or not a country's fiscal policy is likely to be sustainable depends on the state of the world economy. It is difficult to describe the *current* state of the economy; it is impossible to describe every possible future state of the economy and to specify in advance what is sustainable fiscal policy for each state. Once the state has occurred, it is difficult to perfectly observe, measure and verify. Thus, there is no hope that the EU can write and enforce a contract specifying the set of sustainable policies for every contingency.

If the EU restricts itself to simple rules that might be possible to implement and enforce, then there will be frequent instances, such as the situations described in Section 4, where it is harmful to social welfare to follow the restrictions of the rule. In this case nations have the choice of following suboptimal policies or agreeing that enforcing the rule is not sensible and that they should renegotiate. The latter option is unlikely to promote the credibility of EU policy makers and institutions.

5.2. A Sustainability Council. As a consequence of the above, Fatás, et al [1] argue that a fiscal framework based on rules is inadequate for the EU. Instead, we argue for a *Sustainability Council*. The Sustainability Council would be an independent body of technical experts created by, reporting to, and financed by the European Parliament. Its

[5] The Pact requires a time-t surplus of $ib_0/(1+\gamma)^t$.

sole mandate would be to safeguard the sustainability of each member state's finances. Having this independent council would solve the credibility problem of the Stability and Growth Pact: through ECOFIN, national governments judge the quality of their own policies.

The Sustainability Council would comment on policy, but not make it. It would make recommendations on fines for transgressors to the ECOFIN Council; it would have no power on its own to set fines. Its task would be to consider all aspects of country's economic environment and fiscal policy and then to spell out for both policy makers and the public its perceived implications of the government's policies for sustainability.

This Sustainability Council would operate as follows. In the early stage of the budgetary process, say March or April, governments would submit their fiscal plans, for the year or the medium term, to the Council. If the Council finds the plan to be seriously flawed, it would "veto" the plan within two months, returning it to the government with calls for adjustment and suggestions for improvement. Otherwise, the Council would deliver a report no later than October. During the course of the year, the Council would monitor the government's adherence to the plan and would consider changes in economic circumstances that might call for revisions. By commenting on plans, as well as monitoring compliance, the Council would be forward looking, rather than backward looking as is the current fiscal framework.

The Council would have no direct legal authority over nations. Instead, its primary tools would be public opinion and political pressure. It would attempt to educate the public through its commentary and it would formally admonish governments that were not in compliance. It would allow the ECB, national governments, other interested parties and interested experts to participate in its information gathering and processing, for example, by holding hearings. Its reports on a member state would be delivered in that nation's capital.

In addition to political sway, the Council would have the sole right to recommend the imposition of fines to the ECOFIN Council. Consistent with promoting its independence, the decisions of the Council would be final and could not be changed by the European Parliament or any other body. The ECOFIN Council would then either enforce them, or reject them with a majority vote.

The Council would be relatively small, as befits a technical decision-making body. As the process is technical, rather than political, the nationality of the members ought not to be a consideration. Members might be senior academics, public servants or members of international organisations. They must have sufficient individual prestige that their voices would carry weight with the public and member governments.

REFERENCES

[1] Fatás, Antonio, Jürgen von Hagen, Andrew Hughes Hallet, Rolf R. Strauch and Anne Sibert, *Stability and Growth in Europe: Towards a Better Pact*, Monitoring European Integration 13, London, Centre for Economic Policy Research, 2003.