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Reform Proposals for the Stability and Growth Pact

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1. European Institutional flaws: The Sovereignty Paradox

The European "sovereignty paradox" may be summarized as follows: National States and/or the European Parliament, that are the instances in which resides the democratic legitimacy to implement policies and to react to events affecting the economy, are not endowed with the instruments to act or react. The authorities that are actually empowered to act (as the ECB for monetary policy, or the European Commission for fiscal and competition policy), on the other hand, lack the legitimacy needed to use their power to implement policy. Thus we have on one side legitimacy without power, and on the other power without legitimacy.

This institutional paradox has a crucial implication: As power and responsibility are separated, legitimacy to act could not come from the political process, and has to be given other bases. In Europe, these bases have been found in a doctrinal system that sees the role of government of little relevance, if not harmful. Thus, the criteria for assessing "good governance" rest on doctrinal elements (budget equilibrium, market flexibility, structural reforms, and so on).

Another consequence of this institutional construction is the intrinsic lack of reactivity of European policy makers (governments, who would like to react to shocks do not have the power and those who have the power do not have the democratic legitimacy to intervene).

To sum up, the institutional flaws of the European government result in inertia and under-provision of public goods such as the classic ones (defence, infrastructures, education, basic research, energy and environment), and others less often cited, but at least as important as the others: social cohesion, full employment, universal health care, and the like.

2. The Stability Pact as a Constraint on Public Goods Provision

The Stability and Growth Pact (SGP) is grounded on the idea that preserving financial stability is a public good. It aims at preventing excessive deficits and debt build-up in single countries, which would spill over to the other partners in the monetary union via higher inflation and interest rates. In an other briefing paper ("Reform of the stability and growth pact", *briefing paper, European Parliament*, April 2004) I already argued that in fact the SGP, by focussing on intermediate objectives (budget equilibrium, financial stability), neglects, or at the limit hampers, the final objectives of growth and full employment – i.e. overall macroeconomic stability – that are certainly more important for the people of Europe. In other words: based on doctrinal arguments, the SGP favours the public good "public finances soundness", rather than the public good "macroeconomic stability" (i.e. reduction of length and amplitude of slowdown phases) which is at the basis of high growth and low unemployment.

Overall, the Stability Pact may be seen as the more flagrant proof of the European institutional inertia: It is neither respected (12 UE countries, of which 6 also belong to the Euro area, will surpass the 3% limit in 2004) nor scrapped. But still it constrains the room of manoeuvre of national governments. Thus, it is a perfect starting point for a reform process aimed at improving the capacity of European economic institutions of providing European public goods.

3. The Commission Reform Proposal

The recent European Commission communication to the Council and to the European Parliament (*Strengthening Economic Governance and Clarifying the Implementation of the Stability and Growth Pact*, September 3rd, 2004) is centred on a proposal for making the Stability Pact more flexible, which is a recognition that its actual rigidity is harmful to growth.

This communication is a welcome and long awaited step by the Commission, because it constitutes an implicit acknowledgement of the constraints the SGP posed on European growth in the past few years (notably since 2001).

The Commission reform proposal builds on three items: The first is to give more weight to debt sustainability in the assessment of budgetary positions. The focus should according to the Commission be on both current debt and implicit liabilities. Second, the Commission suggests that the medium-term objectives of "close to balance or in surplus" should reflect country specific factors. Finally, the implementation of the Excessive Deficit Procedure should be more flexible, depending on economic developments and circumstances.

If on one side these proposals seem commonsensical and going in the right direction, on the other they may aggravate the paradox of the accumulation of power in the hands of politically non accountable authorities. The assessment of public finances sustainability and of the influence of external factors would be in the hands of the Commission, that would see its power and discretionality increase. This discretionality comes from the fact that the question of debt sustainability is a very complex one which is not really settled by economic theory, all the more complex if it takes into account implicit liabilities which are fairly difficult to estimate. As it is the reform proposal may be interpreted as a mean to force "virtuous" behaviour in

good times, rather than to make the Pact more flexible in bad times. *To reintroduce a debt criterion in the picture may or may not be a good idea depending of the way debt sustainability will be assessed.*

The Commission's proposal would certainly not result in increased flexibility in the short-to-medium run: the average Debt to GDP ratio in the euro area is 71%, which could be substantially higher if we take into account implicit liabilities. Thus for the years (decades?) to come, we can expect national governments to be forced to run restrictive fiscal policies at least as much as they do now. In fact the proposal would give additional room of manoeuvre to countries that don't need it, like Luxembourg, Spain, Ireland, Finland, and none to the countries that are currently experiencing difficulties, most notably Italy, Germany and France which taken together constitute the biggest part of the euro area economy.

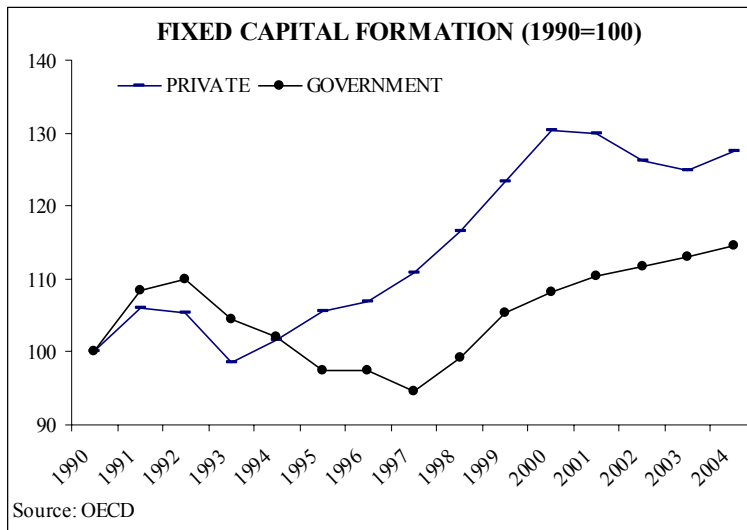
A further problem with the Commission's proposal is that it maintains the "close to balance or in surplus" medium run requirement. That is equivalent to the definition of an optimal debt target of 0% in the long term, a target which has no economic justification, and which is not politically feasible.

4. A Pact for Present and Future Growth

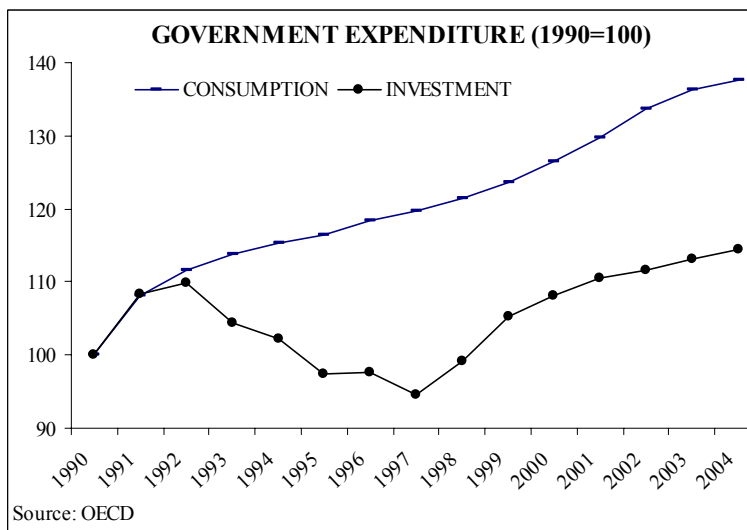
The European construction has as its ultimate goal the building of a better future for its people. Such an objective is attained, among other things, by meaningful and appropriate economic policies. Structural reforms may be an instrument for improving long term welfare, but they are by no means the only one and can't be expected to have strong short to medium run effects. Similarly, while reducing public debt may be an appropriate action in view of long term sustainability of public finances, it cannot be the only objective of fiscal policy. Investment, material and immaterial, is a central item of policies aimed at increasing the growth rate of the economy, the current and the potential one alike. Investment is in fact the main factor behind the provision of those European public goods that as we saw above are in dramatically short supply. When after WWII the European countries faced a continent to rebuild, it is precisely by these public goods that they begun: National cohesion (by means of the implementation of social protection systems), infrastructures, education, basic research. Today we have a similar need, as Europe needs to be also built.

The Stability and Growth Pact may, and must, become the instrument of a common policy to enhance the production of European public goods. As is presently conceived, the SGP is actually playing a perverse role, as government have incentive to reduce precisely the expenditures that are more important for the provision of the European public goods. Current expenditure is in fact the most difficult item to cut, because they are the most visible, and subject to the resistance of vested interests. On the other hand, the main beneficiaries of investment expenditure are future generations that do not have a saying in the current decision making process. Thus, the Stability Pact, by constraining total public expenditure, has in fact been acting as an incentive in restricting investment, less "visible", while current expenditure,

protected by vested interests, remained unchanged. The following figure compares government fixed capital formation with private investment



The figure shows that since the beginning of the 1990s, government investment played a procyclical role decreasing until 97, and then mildly recovering to reach today a level approximately equal to the one of 1992. Furthermore, as the following figure shows, public investment over the 1990s has lost ground also with respect to government consumption.



The figure clearly depicts the bias against investment that has characterized public spending in the past decade, and that I believe was mostly due to the implementation of the Maastricht Treaty before, and to the Stability Pact afterwards.

5. The Golden Rule of Public Finances

It is urgent that the Pact be amended in order to remove the bias against the provision in quantity (and quality) of European public goods. A simple modification of the current setup, namely excluding public investment from deficit figures (the so called golden rule of public finances) would allow removing such a bias. All the current

provisions of the Stability Pact would continue to apply, including the medium term budget balance, but only to current expenditure. Such a simple modification would have a number of attractive features:

- a) The most important is that the provision of public goods would not be constrained anymore. Their quantity, and quality, would become a matter of political choice, and not the result of a doctrinal rule.
- b) Governments facing difficult public finance situation would not be allowed anymore to shrink important but less visible items of their budget, while keeping untouched current expenditure
- c) The long term zero debt ratio objective, theoretically *non sequitur*, would be replaced by a target of the debt ratio equal to the share of public capital in GDP.

Such a modification of the current setup would not require a rewriting of the Treaties, and the complex ratification procedure that this entails. In fact, article 104.3 of the Treaty is sufficiently vague to allow for a different definition of the deficit figures relevant for the implementation of the Pact. The only modification required would be one of the regulations that are part of the Stability Pact. In fact, Regulation # 1467/97, detailing the Excessive Deficit Procedure, should be amended in order to exclude Net Capital Formation from deficit figures. Such an amendment only requires a unanimous vote from the Council.

6. The Golden Rule as an Embryo of European growth and Industrial Policy?

One of the most common objections to the Golden Rule is that it would *de facto* constitute a relaxation of the current setup, because the definition of public investment is so vague that countries could fit in it almost any expenditure they were willing to carry on. While this is certainly a possible danger, there are ways to prevent such a behaviour that could eventually even result in a better opportunity. In fact, the definition of what items can be classified as investment, and hence excluded from deficit figures, should be given to the Council (preferably after consulting the European parliament), which should in turn use it as an instrument to implement an European growth and industrial policy. Thus, the countries could be given the liberty to spend in these areas that the Council and the European Parliament deemed important for the attainment of its general objectives, for example the European Transportation Networks, or R&D in particular fields, or the knowledge economy, and so on.

Thus, a possible weakness, the vagueness of the definition of public investment, could be transformed in an opportunity for growth policy coordination, through the definition of incentives for single countries to invest in particular areas of common interest. The Council would thus acquire a real impulse power in these domains, and for once Europe would act by incentives rather than by constraints.

To conclude, the exclusion of public investment from the Maastricht criteria boils down to protecting future generations from current ones, and the democratic process of political choice from doctrinal rules.