Towards a new Stability and Growth Pact

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1 Fiscal policy: Lessons from Brazil

During 2002 Brazil was hit by a severe financial shock. The increase in bond spreads in the U.S.–induced by the demise of Enron– and the domestic political uncertainty–associated with the presidential campaign which started in March of that year–combined to increase the risk premium on Brazilian bonds sharply. In a few weeks the Brazilian Embi spread jumped from 750 basis points–a normal level for an emerging market economy–to above 1800. The rise in the risk premium was accompanied by a depreciation of the exchange rate: with one half of the public debt either denominated in dollars, or linked to the dollar, the cost of debt service rose rapidly

Prior to the shock Brazil's debt level had been stable since the devaluation of January 1999, hovering around 52 per cent of GDP. Stability of the debt ratio was the result of a primary surplus consistent with the cost of debt service: this meant a level of the primary surplus close to 3.5 per cent of GDP.

When the shock hit the economy, the Brazilian authorities had two options. Double the primary surplus, so as to keep the debt ratio unchanged at the new level of interest rates, or reassert their commitment to medium term fiscal stability, but let the debt ratio temporarily increase. Neither option was easy. The first would have meant defaulting on government payments–the only way to reduce spending by such a large amount in a very short period of time–or introducing some kind of wealth tax–another form of default. Both would have added a further negative impulse to an economy already hit by real rates as high as 15 per cent. The alternative, letting debt temporarily grow, required lots of credibility.

In the event the Brazilian authorities–including, importantly, the front-runner in the campaign, Ignacio Lula da Silva–reasserted their commitment to keep the primary surplus at the level required to guarantee the stability of

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the debt ratio under "normal" conditions.[1] The trick eventually worked. By early 2003, when U.S. spreads started falling and the political uncertainty was eventually resolved, the Embi spread returned below 500 basis points–a level at which a primary surplus of 3.5 per cent of GDP was slightly in excess of what was needed to stabilize the debt ratio.

One could ask what the outcome might have been had Brazil decided to play tough and stop the debt from growing whatever the cost. It is not difficult to foresee a scenario in which an accelerating recession would have invalidated whatever action the authorities were taking on the fiscal front–a vicious circle in which the credibility of the government would have rapidly eroded. Eventually, as we know, it was a happy ending. The temporary increase in the cost of debt service added only 2 percentage points to the debt-GDP ratio, and the output cost of the "sudden-stop" was the smallest of among the recent emerging market crises.

Latin American crises are often extreme experiences. Still it would be wrong to overlook them. The lesson I take from Brazil is that commitment to medium term fiscal stability is a better strategy than concentrating on incredible rules that put all the weight on the short term.

2 The fundamental inconsistency of the Commission's reform proposal

The Stability and Growth Pact (SGP) is an example of an ill-designed set of fiscal rules. As the experience of the past few years suggests, the SGP provides no incentives to address medium term fiscal sustainability. Consider two countries, one with a balanced budget, but nurturing a time bomb in its social security accounts; the other with a sustainable pension system, but a temporary downfall in fiscal revenues, possibly the result of a moderate recession. The SGP will punish the second one. It will also not punish a country that has shifted a large fraction of public investment off its books creating a special purpose vehicle. But it will punish a government that adopts a wide-ranging fiscal reform, and in the process incurs a temporary deficit.

The official reform proposals–from last September's Commission's Communication (COM, 2004, 581) to the recent "Key Issues Paper" produced by the Economic and Financial Committee (EFC)–recognize these shortcomings, but

[1] "Some analysts take current values for growth, real interest rates and the real exchange rate - based on today's extremely negative circumstances - and assume that they will hold for the rest of the decade in order to argue that Brazil's finances are not sustainable. But why should a country with a substantial primary surplus, a sound banking system and a floating exchange rate not move over time towards single-digit real interest rates? Why should it not reach its potential GDP growth of 4.5 per cent as it did from late 1999 to early 2001? In addition, with a portion of the debt linked to the exchange rate, any future appreciation of the real in real terms - this is likely to happen in the medium run given current undervalued levels - will further reduce the debt-to-GDP ratioTrust Brazil", Arminio Fraga and Ilan Goldfajn, Financial Times (September 18, 2002).

stop short of proposing an overhaul of the system. The reason is that all these plans take as a given the constraint that the Treaty cannot be changed–some are also drafted under the further constraint that Regulation 1467/97 (the Regulation that accompanies Article 104.C of the Treaty and spells out the precise conditions for the application of the Pact) should be left unchanged. The result is a fundamental inconsistency–as the Bundesbank was fast to notice when the Commission plan was announced, defining it "a move in the wrong direction".

By envisaging more discretion, but taking the Treaty as a given these proposals run into a fundamental inconsistency. The inconsistency is between the increased discretion that a shift towards medium term fiscal objectives requires and the absence of governance mechanism to exercise such discretion. The Treaty was written having simple rules in mind, and does not provide a framework for the exercise of discretion.

Why the Commission's plan would not work

The Commission proposes, essentially, to move from rules to discretion. Instead of uniform and directly enforceable rules, it recommends moving to a decison-making process based on prior analysis by the Commission itself. The framework for such an analysis should be medium term fiscal sustainability. Debt levels and debt dynamics, rather than the yearly deficit, should be put at the center of a country's review. A low-debt country could aim for a medium term budget deficit–rather than budget balance. And should its deficit exceed 3% during an economic slowdown, it would be given more time to correct it. Similarly, a country whose deficit originated from growth-enhancing investments, or resulted from the adoption of structural reforms, would be treated differently from one whose deficit resulted from public consumption. None of this would be allowed in the case of a high-debt country, whose debt level is not falling fast enough. The Commission would act as the judge.

This proposal runs into two difficulties: both have to do with governance.

To monitor fiscal policy effectively, the Commission's services should be strengthened and, above all, made more independent. Today the Commission's assessment of a country's fiscal stance is weaker than that produced by the IMF staff during an Article 4 consultation–also because the Commission staff must rely, more so than IMF staff, on numbers provided by the services of the member state under investigation. In the Commission's review process there is nothing like the preliminary conclusions, drafted in the form of a Letter to the Authorities, that the head of an IMF mission drafts on the day he leaves the country. As noted by Pisani-Ferry (2004), Commission assessments are subject, de facto if not formally, to a green light by the country's authorities, often involving strategic bargaining. Put more discretion into this process, as the Commission's plan proposes, and the bargaining could easily become unruly

One example is the proposal–in the Commission's paper– that the "exceptional circumstances" that justify, in the case of a low debt country, exceeding the 3% limit, be extended to include not only sharp recessions (the current rule says "a fall in output in a single year exceeding 2%") but also prolonged periods of output growth below potential. It is easy to forsee how both the meaning of "prolonged" and of "potential growth" could become the subject of bargaining. Who whould have the final word? (By the way, this interpretation of the 3% limit puts an end to the discussion of whether 3% is large enough to accommodate the rise in the deficit during a recession: 3% would no longer be a limit.)

The second issue is also related to governance. The draft constitutional treaty gives the Commission, and no longer the Council, the right to issue an "early warning". But early warnings would keep being written on the sand since the final decision on whether a member state infringes the rules, and should thus be fined, would remain with the Ecofin Council. It is as if the ECB had the authority to propose interest rate changes, but the final decision rested with the Ecofin.

How can we make sure that the Council does not arbitrage between different decisions, for instance between a fine raised because of an infringement of the SGP rules, and a country's acceptance, for example, of a new investment directive? Implicit in the Communication is the view that the Commission should have, when it comes to applying the SGP, the same executive power the ECB enjoys in the area of monetary policy–or the Commission itself in the area of competition policy. But the Treaty does not allow this, and the Commission, taking the Treaty as a given, does not request it.

To sum up: By shifting away from automatic rules and enhancing the idea of medium-term sustainability, the Commission's proposal moves in the right direction. But the plan falls apart when it comes to governance and enforcement. The reason is that the treaty was written to govern a process based on simple rules and does not allocate decision-making power in the case of rulings based on discretion.

3 The "Key Issues Paper" and the current state of the policy process

Current discussions on SGP reform are based on a document ("Key Issues Paper") produced in November by the Economic and Financial Committee (EFC). The document puts forward six questions to the members of Ecofin, that I have here reproduced in an Appendix.

The Key issues Paper takes the Commission's Communication as its starting point, including the view that *"the Treaty will not be changed. Changes to the SGP provisions, if any, should be minimal. At the core of the budgetary framework for the functioning of EMU, defined by the Maastricht Treaty, are the 3% of GDP general government deficit and 60% of GDP government debt nominal reference values."*

The paper thus shares the same inconsistency as the commission's Communication. Question #6, where governance is addressed, doesn't go beyond the wish that Ecofin and the Commission *"improve their interaction in budgetary surveillance."*)

Having shifted aside the issue of governance, the policy controversies concentrate on the framework within which discretion should be exercised. Five points remain unresolved:

- The shift to medium term sustainability puts debt dynamics at the center. Should this become a new operational criterion–such as requiring that countries exceeding the debt limit should satisfy, beyond the 3% deficit rule, also a criterion on the rate of debt growth?
- Should the definition of "public debt" be limited to financial liabilities, or should it also include an estimate of liabilities that arise from the aging of the population: pensions and health? (Surprisingly, the proposed definitions of the relevant debt number do not include government guarantees, which are frequent in some countries.)
- Should countries that exceed the debt limit have access to the provisions that allow the medium term fiscal target to be less severe than the current requirement of budget balance over the cycle?
- Countries that implement structural reforms might be allowed to deviate from the objective of medium term fiscal balance (possibly also to exceed the 3% limit), if such reforms induce a temporarily higher deficit. Should such a rule apply only to pension reform or to tax reforms as well?
- Should the situations that might allow a country to deviate from preassigned fiscal targets include public investment? Should the new rules go as far as allowing for the "golden rule"?

It is obvious that underlying these five points there are two politically contentious issues: debt levels and tax reform. Some countries have already indicated that they will not accept reforms that introduce new rules on debt growth. Some have also indicated that they favour an interpretation of structural reforms that includes tax reform. These are likely to be the two contentious points at the January Ecofin meeting where the EFC paper will be discussed.

4 Two ideas on how to solve the inconsistency

I see two ways out of the inconsistency the policy process has fallen into:

- Improve the SGP while keeping it a rules-based system. The idea here is to adopt a "correct" golden rule which would not require a Treaty change.
- Accept that discretion raises governance issues that the Treaty is ill-suited to address and change the Treaty. The idea here is to shift the governance of fiscal discretion to new institutions at the individual country level.

4.1 The correct "golden rule": an improved rules-based system consistent with the Treaty

The SGP contains a serious error: the way governments are expected to account for public investment. Blanchard and Giavazzi (2003) have proposed that is error is corrected and, as article 104.C of the treaty allows, the current rules be applied to a measure of the budget where the treatment of investment expenditures is done properly–which means applying the SGP to the budget inclusive of nominal interest payments and of capital depreciation. Excluding net investment would have several desirable characteristics:

- *It would remedy an obvious mistake in the way the SGP was written.* A private company does not attribute the entire cost of an investment project to a single year's accounts. Investment implies future returns: its cost should thus be distributed over time as those returns accrue. Amortization of investment expenditures by governments is not allowed by the SGP, although the Treaty does not prevent it. Removing financial constraints on public investment is important in the euro area. First, gross public investment in the 12 EMU countries has been on a downward path since the mid 1970s, falling, as a share of gdp, from 4% in the early 1970s to less than 2.5% in 1998. In particular public investment fell by 0.8 percentage points during the run-up to the euro (1993-97). Today average gross investment is 2.4 per cent of GDP, but net investment is probably close to zero in Germany, Italy, Belgium and Austria.[2]

- *Over time the debt-gdp ratio to the ratio would tend to become equal to the ratio of public capital to gdp.* Although there are different arguments for why the optimal stock of public debt may not be zero (intergenerational transfers is one), financing investment projects with a sufficiently high social rate of return is certainly one.

- *It would introduce more transparency in the budget.* The inability to treat public investment differently from current expenditure has created, in some countries, the incentive to shift borrowing off-budget. Italy, for instance, has recently set up an agency fully owned by the government but not consolidated in the government accounts, whose purpose is to finance and run public investment projects, borrowing on the market. There is nothing wrong with investment agencies as such: the separation of the 'current' budget from the 'capital' budget has a time-honored tradition in public finance. What is inappropriate is the lack of transparency. The accounts of these agencies, for instance, make no distinction between gross and net investment, and thus fail to recognize that depreciation of public capital is equivalent to current expenditure and should be treated as such in the consolidated government accounts. The agencies have no clear

[2] Gali and Perotti (2003), however, find much weaker evidence of an effect of the run-up to Emu on the ratio of government investment to potential GDP.

limits on the amount they can borrow. The bonds they issue are guaranteed by the government, but such guarantees are not recorded in the government books. Thus the debt they issue is not considered as part of the public debt. The European Commission has questioned these guarantees, arguing that they are often equivalent to state aid. There certainly are instances–and the recent capital injection by the KfW into a German private communications company is one example–when these agencies engage in state aid. But this is not the case in general: subsidizing public projects whose social return exceeds their financial return is one of the reasons government exist. (For a theoretical argument in favour of capital budgets, see Bassetto and Sargent, 2004).

- *Excluding net public investment from the definition of the budget that is relevant for the SGP would also help in the short run.* Consider Germany, for instance, one of the countries where a change in the rules would apparently not matter, since net public investment today is essentially zero. With the current interpretation of the SGP, and assuming that German output is below potential by an amount large enough to justify the entire use of the 3 per cent band–which is probably the case–Germany would need to cut the deficit by at least 0.8 per cent of gdp. The modified rule also requires fiscal action, but of a very different type: instead of a cut in demand, it allows for a substitution of current expenditure with an equivalent amount of public investment.

No need to change the Treaty

A rule that allowed for the proper accounting of government investment, separating it from current expenditure, appears to be consistent with article 104.C. The article reads: *"If a member state does not fulfill the requirements under one or both of these criteria [deficit below 3 per cent and debt ratio approaching 60 per cent at a satisfactory pace], the Commission shall prepare a report. [Such report is the starting point of the procedure possibly ending in sanctions.] ... The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and ....*". . Note that the article is actually too lax as it makes no distinction between gross and net investment, thus allowing for the (incorrect) possibility of treating gross investment differently from other expenditure, rather that only net investment.[3]

The SGP would remain a rules-based system

Introducing a "corrected" golden rule would not modify the rules-based character of the SGP and would therefore avoid the governance issues discussed

[3] Article 104.C is currently interpreted by two Regulations, issued by the European Council, which specify how it should be interpreted. Regulation 14676/97 lays down the rules. To implement this proposal, the Regulation should be amended specifying that the current rules, including the excessive deficit procedure, apply to the budget excluding net capital formation. The Regulation should also assign to the Statistical Office of the EU the task of issuing rules for computing the amortization of public capital. These amendments would require a unanimous vote of the European Council but not a Treaty change.

above. A delicate aspect is obviously the definition of governemt investment, since there is the risk that current expenditure by re-classified as government investment. This is a task for the Statistical Services of the Commission. It is not an easy task, but certainly easier than deciding whether debt dynamics are under control. Importantly, it is a task that could be delegated to the Commission, thus avoiding potential conflicts between Ecofin and the Commission and bargaining within Ecofin.

5 The governance of fiscal policy. Fiscal policy committees

The alternative is to face the governnace issue head on.

The obvious solution is to give decision making power to the Commission. As an independent body the Commission is not subject to the political incentives that make the Council an unreliable decision maker. This would require a Treaty change. But even if such a change was was possible, the solution would also have to respond–I don't know how–to the objection that the Commission has almost no political legitimacy. While desirable, this remains an unfeasible solution.

Charles Wyplosz (2002) has proposed a solution to the governance issue which essentially shifts responsibility for setting fiscal policy back to national institutions. The idea echoes the concept of "ownership" which often comes up both in the Commission Communication and in the Key Issues paper: "fiscal committments will only work if national institutions feel they own them." Rules that are imposed from the outside give rise to resentment and eventually to confrontation. The outcome is bad for European institutions and bad for fiscal policy itself, as the 2003 clash between Ecofin and the Commission has demonstrated.

To solve the problem of how to excercize fiscal discretion, Wyplosz suggests that we look no further than the experience of monetary policy. Monetary policy needs to deliver price stability in the long run while being flexible enough in the short run to deal with business cycles. The successful recipe has been, almost everywhere, delegation to a group of competent people - the central bank - by making them formally independent from political pressure and providing them with a clear, explicit mandate. Knowing that any slippage today will need to be dealt with tomorrow, they exercise their best judgment. This has been a spectacular improvement over the monetary rules of the past.

The same approach should work for fiscal policy. Some, of course, may fear a loss of democratic accountability. It is essential to realize, notes Wyplosz, that fiscal policy fulfills two very different tasks. The first task is structural and redistributive: it concerns the size of the budget and its detailed structure on both the spending and revenue sides. Decisions on such issues cannot be delegated; they must remain in the hands of elected governments and be subject to parliamentary approval and oversight. The second task is macroeconomic: it is about setting the budget balance to deal with cyclical fluctuations. That task does not differ from monetary policy and can be delegated to an independent body.

Each country should regain full control of its fiscal policy but delegate its macroeconomic component, decisions about deficits or surpluses, to an independent *Fiscal Policy Committee* given the long-run mandate of stabilizing, or in some countries reducing, the size of the public debt. In order to guarantee the outcome, the statutes of such committees and their mandates ought to be agreed upon by all euro members. No more Brussels interference, no more arbitrary rules, no more political judgments– just plain common sense.

6 Summing up

The policy process is moving in the direction of less rules, more discretion and shifting the emphasis to medium term fiscal sustainability. This is the righ direction. But the Treaty was written to govern a rules-based system, not one based on discretion. Absent a change in the Treaty the new system risks creating a policy vacuum: the consequences of such a vacuum have been clear in the 2003 clash between Ecofin and the Commission where the solution has been: Let's ask the Court of Justice.

In my view there are only two ways out. Be serious, recognize that discretion needs a clear allocation of decision-making power and add this to the Treaty. Alternatively the SGP could be improved keeping it a rules-based system. a corrected goldedn rule would be the way do this.

7 References

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8 Appendix

Questions for Ecofin in the "*Key issues non-paper: Strengthening, clarifying and better implementing the SGP*" prepared by the Economic and Financial Committee, November 2004

1. What kind of additional instruments and incentives would be required to ensure budgetary discipline in "good times"? Should they include peer pressure, such as more timely early warnings? What domestic instruments could be developed to strengthen fiscal consolidation in "good times"?

2. Do Ministers agree that further work should be carried out to take medium and long term sustainability considerations into account in the definition of the medium term objective, in particular implicit liabilities related to ageing, in so far as their estimates are sufficiently robust? Do Ministers consider that the target of 0.5% of GDP improvement in the underlying deficit is still appropriate?

3. Do Ministers agree on the opportunity to enhance the importance of the debt criterion in budgetary surveillance? Can this be achieved while avoiding mechanistic approaches? Would a framework of assessment for a satisfactory pace of debt reduction be helpful?

4. Assuming that economic growth developments were to play a larger role in the excessive deficit procedure, would Ministers prefer to take them into account when deciding on the existence of an excessive deficit (i.e. through the "exceptional and temporary circumstances" clause) and/or when setting the appropriate adjustment path; or not at all?

5. If the impact of reforms is to be considered in the budgetary framework, should all sustainability-improving reforms be taken into account or only those with a clearly identifiable budgetary impact in terms of short-term cost and direct benefits in the long term, such as pension or tax reforms? Should the budgetary impact of structural reforms, as well as public investment and/or the quality of public expenditure, be taken into account with regard to the adjustment path to the medium-term targets? Or should they also be catered for by the Commission when making a qualitative assessment in the report under 104.3?

6. Do Ministers agree that a good functioning of the Stability and Growth Pact requires the political commitment to implement the rules vigorously and provisions to increase national ownership? Do Ministers agree that Member States should consider the quality and integrity of their statistics as a priority matter, and apply the highest standards in the domain of statistics? Do Ministers agree that confidentiality is warranted as long as discussions are ongoing, while being transparent on the positions of EU institutions once decisions have been taken?