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Basic Redress or Incremental Adjustment? On Recent Debates about the Reform of the Stability and Growth Pact

*Waltraud Schelkle**

In a substantive paper, Buti et al. (2003) discuss various criticisms of the European Stability and Growth Pact and propose a number of amendments. The bottom line of their review is that reform requires internal adjustment only, keeping the norm of relying on rule-based fiscal consolidation and automatic stabilisation. By contrast, I argue that their proposals imply not merely internal adjustment but a basic redress of the Pact's thrust. If implemented they would turn the existing disciplinarian device confined to national budget consolidation into an insurance arrangement for collective stabilisation. This insurance perspective suggests to go further down that route to make coordination sustainable.

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I. Introduction

Ever since its inception, the European Stability and Growth Pact (SGP) has sparked controversy on how much room for fiscal manoeuvre should be granted to member states of a monetary union. Traditional macroeconomics, above all the theory of optimum currency areas, suggests that governments need effective and perhaps additional means of fiscal stabilisation when monetary policy is unified. By contrast, the new political economy of

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macroeconomics focuses on problems of credibility and time consistency of stabilisation policies and consequently stresses the advantages of tying governments' hands by fiscal rules. These latter considerations of the new political economy prevailed in the design of the SGP. The Pact has not provided any additional instrument of fiscal policy, such as a rainy day fund or community stabilisation mechanisms, while it tried to constrain governments in running deficits. Yet, having failed with respect to this overriding goal, the debate on how to reform the SGP or economic governance more generally is on again.

In a substantive paper available on the Commission website, Buti et al. (2003) discuss the various criticisms of the Pact and propose a number of amendments. Despite the usual disclaimer, this paper can be read as the most explicit statement of the position that the Directorate-General of Economic and Financial Affairs, that is the Commission department responsible for operating the Pact, holds.¹ The authors make a welcome attempt to overcome the ad-hocery of the present debate and aim instead at reforms based on a »systematic analysis [...] of the ›quality‹ of the existing fiscal rules.« (Buti et al. 2003: i) The bottom line of their review is that reform requires only internal adjustment, keeping the norm of relying on rule-based fiscal consolidation and automatic stabilisation.

By contrast, I will argue that their proposals imply more than just internal adjustment but a basic redress of the Pact's thrust. If implemented, they would turn the existing disciplinarian device, confined to enforce national budget consolidation only, into an insurance arrangement that provides for collective stabilisation. This insurance perspective suggests ways to complement their reform proposals in order to make coordination sustainable.

In the next section, I summarize the discussion in Buti et al. (2003). This is followed in the third section by an outline of the insurance perspective of fiscal policy coordination and SGP reform to be contrasted with the disciplinarian view informing the existing Pact. In the fourth section, I argue that more than internal adjustments are implied by the Buti et al. (2003) proposals, in particular that their emphasis on automatic stabilisation requires sizeable government budgets while it is compatible with declining stocks of public debt. The fifth section sums up by suggesting ways to go further down the route that Buti et al. (2003) suggested.

2. The major reform proposals

The following criticisms and consequent reform proposals are considered by Buti et al. (2003):

1. The numerical three percent deficit-ceiling of the SGP, only to be breached in exceptionally severe recessions, is criticized for reducing budgetary flexibility. Alternatively,

1 The paper collects and modifies reform proposals that the Commission ventured for some time (European Commission 2002). Marco Buti has become Director of the department »Economies of the Member States« that is responsible for public finances after its publication.

critics propose to replace the numerical target and the Excessive Deficit Procedure by other institutions, such as reformed budget procedures at the national level and an independent fiscal policy committee at the EU level, to tackle the problem of fiscal spill-overs and discipline (Wren-Lewis 2000, Wyplosz 2002).

2. The SGP is criticized for its sole focus on deficits, thus operating asymmetrically. In particular, the rules do not sanction procyclical policies in booms or over-expansion in the run-up to elections.² Various proposals for maintaining structural balance, that is one which requires balance or a sustainable deficit not annually but over the entire business cycle, aim at alleviating this problem (de Haan/Sturm 1997, Korkman 2001).
3. The norm of fiscal policy under EMU, namely to maintain a budget »close to balance or in surplus«, is criticized for discouraging public investment since that calls for its financing largely out of current revenue. Political economy also suggests that fiscal consolidation is typically achieved by reducing public investment more than current expenditure such as spending on civil servants' salaries. Again, the move to a structural target, in particular expenditure rules or a »Golden Rule« which allows to finance capital expenditure (and only capital expenditure) by credit, would take care of that criticism (HM Treasury 2003).
4. The SGP is criticized for providing incentives only for short-term deficit reduction but not for making national fiscal policies sustainable in the long run. For the latter to be the case, rules should focus on the stocks of public debt rather than deficit flows; and they should be differentiated according to members' debt levels and long-term obligations such as expenditure on public pensions. A Permanent Balance Rule as devised by Buiter/Graefe (2002) or the Debt Sustainability Pact proposed by Pisani-Ferry (2002) would both serve this purpose.
5. Lastly, the SGP with its aim to enforce national fiscal consolidation is criticized for disregarding the aggregate fiscal stance and thus macroeconomic stabilisation of the euro area. To address this problem fiscal policies would have to be coordinated with a view to achieve an EMU-wide fiscal balance that complements the monetary stance (Collignon 2001, Schelkle 2002). A practical and innovative idea is that of Casella (1999) which proposes to allocate tradable deficit permits to member states, the aggregate volume of which would be determined by the desired fiscal stance.

According to Buti et al. (2003), the debate about SGP reform needs to be situated within a larger debate about the quality of fiscal rules and how it can be improved.³ Thus, only those proposals that imply an improvement of the existing rules are considered, while more radical proposals (e.g. Beetsma/Bovenberg 1998) that suggest to substitute for the

2 Buti et al. (2003) differentiate between the two instances of asymmetry and therefore report six allegations.

3 See for more recent work on the quality of fiscal rules Beetsma (2001), Kopits/Symansky (1998), Kopits (2001), and Banca d'Italia (2001).

SGP by a combination of reformed national procedures and financial market discipline are dismissed. The basic arguments are that re-nationalisation does not take into account »an enduring mistrust among euro area member states« (Buti et al. 2003: ii), while financial market discipline is considered unreliable without a signalling device such as the SGP (Buti et al. 2003: 14). The reform package that they propose has four components, responding to the first four criticisms:

- Independent enforcement: A major weakness of the present rules is the partisan enforcement by the Council, i.e. by member states who may themselves be subject to sanctions. Buti et al. (2003) propose instead to give the Commission the right to determine whether the rules have been breached without the approval of the Council. The Council would then have the right to decide on the political measures that the respective government has to implement. Sanctions would be implemented upon a proposal by the Commission which, in contrast to a recommendation as at present, the Council can only strike down by unanimous vote.
- Symmetric intervention: The early warning mechanism should also be used to signal fiscal policies are not tight enough in good times. A rainy day fund, i.e. one that finances additional expenditure in recessions and is replenished in booms, could help governments to comply with the budget rules if present accounting rules are changed. Using the fund in recession would then be counted as additional revenue, thus lowering the deficit even though it allows for more counter-cyclical expenditure, and vice versa in good times. Buti et al. (2003: 26 f.) also hope that this would allow to implement sanctions more strictly. Presumably, governments would be less reluctant vis-à-vis sanctions, both as enforcers and as those susceptible to the sanctions, if these non-interest bearing deposits would benefit a rainy day fund on which they may draw in a future recession.
- Targeting structural balances: To »improve transparency in present and perspective fiscal accounts«, Buti et al. (2003: 24 f.) propose to measure the balance target in structural terms, i.e. allowing for cyclical fluctuations and disregarding one-off measures such as proceeds from the sale of UMTS licences. This could be complemented by indicating off-budget balance liabilities such as pensions administered by autonomous public funds as in Germany. All these measures are supposed to give a better picture of the medium and long term fiscal position.
- Diversification of targets: Based on common estimates of contingent liabilities and net investment, member states could be given structural balance targets depending on their stock of public debt and future liabilities, in particular from public pensions. For countries with sustainable public finances, this would amount to a structural deficit target of 1 – 1.5 percent of GDP. This »minimal benchmark« would ensure that countries do not violate the three percent deficit target when automatic stabilisers are in operation during recessions. The authors also maintain that this would in most cases be compatible with a Golden Rule, i.e. financing a steady level of investment including amortisation by public debt.

Against the background of the major allegations and reform proposals that Buti et al. (2003) reviewed, the contents and rationales of their package are remarkable in two respects: First, while they take up all issues raised in the literature, that of the aggregate fiscal stance is conspicuous by its absence. Second, while they do take up all but one issue, in two cases the rationales they give are interestingly different from those of other authors who raised them. In particular, they propose a rainy day fund to discourage pro-cyclical policies in good times and to facilitate stricter enforcement of sanctions. Moreover, they propose a structural balance target to improve transparency while they do not even mention the basic macroeconomic rationales for such a reform, namely to make the goals of stabilisation and consolidation more compatible and to prevent the need for pro-cyclical fiscal policies in recessions. The next section argues that these propositions show the authors' subscription to the disciplinarian world view, yet the proposals they endorse make considerably more sense as part of an insurance arrangement.

3 Two views of policy coordination and reform of the SGP

3.1 The insurance approach

The starting point of an insurance view of policy coordination is uncertainty: Policy coordination can help risk-averse authorities to achieve not only the warranted *level* of an objective but also the warranted degree of its *volatility*.⁴ Under uncertainty and in the absence of coordination, governments do not fully offset shocks to an objective since a more active use of policies typically increases volatility. Thus, each goal requires two instruments. Uncoordinated action will be overly contractionary or expansionary, depending on the qualitative influence of the multipliers that link instruments to goals, because goal attainment as regards the level has to be traded off against goal attainment as regards volatility. This suboptimal stance of uncoordinated policies is transmitted to other countries if economies are interdependent. Governments therefore have an incentive to engage in coordinated action. It can be thought of as providing an additional instrument which allows to achieve a superior combination of target level and volatility, both for the individual country and for the integrated area (Ghosh/Masson 1994: 42–44).

A monetary union that is an insurance arrangement is guided by the maxim »risk sharing rather than self-reliance«. The tradeoffs between discipline and flexibility and between prudence and sovereignty that Buti et al. (2003) note translate into a political-economic trade-off between insurance and independence. Joining a monetary union not only presupposes that the economic incentives are right, that is members consider it to be fair and their contributions will be matched by expected out payments. Membership also

4 It draws on the macroeconomic theory of policy coordination under uncertainty (Ghosh/Masson 1994) and the theory of finance which explores contract failure and design in the presence of principal-agent problems. For public policy as risk management see Moss (2002) and Shiller (2003).

presupposes a certain amount of political trust in other members of the insurance pool, namely that they are not an adverse selection of high risks and do not overwhelmingly change their behaviour to the detriment of others in the insurance pool. While the older literature on macroeconomic policy coordination can easily be reformulated to take the purely economic aspect of insurance into account, it has arguably neglected the endogenous risks of insurance, that is the agency problems of moral hazard and adverse selection captured by the latter political aspect. Thus, an insurance approach takes valuable insights of the new political economy of macroeconomic policy into account without losing sight of the conventional concerns of stabilisation that motivated the older literature. Given the preoccupation with dynamic inconsistencies of policymaking in the recent literature, it seems high time to bring these macroeconomic concerns to the fore again.

What does this view tell us about reforms of the SGP? In this section, I take up the proposals by Buti et al. (2003), while reforms that would go beyond theirs are discussed in the fifth section.

- Independent enforcement: At present the Ecofin Council assesses the insurance case. This means that providers and recipients of insurance are identical which makes them susceptible to moral hazard, i.e. they assess the case for insurance too favourably or too unfavourably. Automatism is not an appropriate alternative either if not all inflation or unemployment is »engineered« by policymakers but the uncertain result of market forces of which the government is just one among others. The job of a non-partisan body therefore is to separate insurable exogenous risks from uninsurable endogenous risks that arise from moral hazard. Thus the insurance view and the disciplinarian view concur on that proposal and even on the same grounds. If one would like to mention any difference, it is that the present arrangements are even more of an anomaly for the disciplinarian view because here policy coordination is built on mistrust in other members.
- Symmetric intervention: At present, the SGP prescribes regressive burden sharing, that is the country in fiscal difficulties would bear the brunt of adjustment. Insurance in contrast is about fair burden sharing among members of an insurance pool which means in the strict sense of actuarial fairness that the insured can expect to get out of the insurance as much as they pay into it over time. A rainy day fund or a community stabilisation mechanism entails such symmetry even without any suspicion against member states, since it has to be financed out of contributions from members that experience a boom so that member states in recession can draw on it. The obligatory participation in such a scheme would act as a mechanism to reveal preferences for a certain amount of political integration that is required for policy coordination as insurance. The moral hazard problem could be dealt with as in any financial contract, namely insurance that is only partial in that a co-payment is due if the insurance case arises. Analogously, fiscal transfers from a community stabilisation scheme may only partly or temporarily compensate the regional economy in a downturn (Italianer/Pisani-Ferry 1994: 181).

- Targeting structural balances: If discipline is the paramount goal of fiscal policy coordination, a structural target is a risk since it is open to interpretation and statistical manipulation.⁵ It is most pertinent in an insurance arrangement, however, since the need for insurance arises when economies are typically off the steady state. A structural target then allows to take care of stabilisation and of consolidation, that is to combine curative risk management of income fluctuations (stabilisation) with precautionary risk management (consolidation) that will make the insurance case of otherwise unsustainable deficits less likely in the future.
- Diversification of targets: The present stipulation for every country to meet the three percent deficit criterion as well as have a budget close to balance or in surplus does not make much sense from a disciplinarian point of view. It is, however, a standard instrument of private insurers to differentiate premia with respect to risks, for instance to have higher health insurance premia for smokers or people who pursue accident-prone hobbies like skiing. Yet, to the extent that insurers differentiate, they do not pool risks. Thus, diversification impairs the amount of insurance provided. It can still be justified as an analogue to a co-payment that gives incentives to avoid or at least not to provoke the insurance case.

All this suggests that the Buti et al. (2003) proposals make sense in substance but decidedly less so within a disciplinarian approach.

3.2 The disciplinarian approach

The first aim of the Buti et al. (2003) proposals, explicitly stated by the authors, is getting a better economic trade-off between discipline and flexibility: medium-term budget targets to improve transparency of the fiscal situation, the early warning mechanism and a rainy day fund to combat pro-cyclical fiscal biases. All these suggestions presumably shift the trade-off so that the same degree of discipline allows for more flexibility and vice versa. The improvement materializes only in the steady state, as Buti et al. (2003: 2) explicitly note, when fiscal variables such as the stock of debt are on a sustainable path. Because only then will more transparency and symmetry not lead to tighter monitoring but to additional support for a fundamentally viable fiscal regime.

Second, reforms try to preserve the existing political trade-off between prudence and sovereignty: fiscal policies remain decentralised and coordination bound to be of the negative type, that is consisting in mutual surveillance only, while enforcement would become non-partisan and impartial. The attempt at mere preservation of this trade-off explicitly accepts existing preferences for political integration which is, to use Buti et al.'s (2003: 2) frank expression, characterized by »enduring mistrust« between members.

⁵ Different statistical filters to eliminate the cyclical trend give quite different results, see Bouthevillain et al. (2001).

The focus on the steady state and taking preferences for a low degree of political integration as given together make for a reform perspective guided by the maxim »rules rather than discretion«. This maxim was originally directed at national policymaking (Kydland/Prescott 1977) and is characteristic of the new political economy of macroeconomic policy (Cukierman 1992, Drazen 2000, Persson/Tabellini 1994). Based on the methodological innovation of rational expectations applied to political economy, this literature spots dynamic inconsistency of optimal plans everywhere in policy-making (Barro/Gordon 1983, Giavazzi/Pagano 1988). Dynamic inconsistency means that policy-makers have incentives to change policy measures as times go by even though they are optimal in the steady state at the time of announcement. Some, not necessarily perfect information about policy-makers' incentives makes the representative private actor to anticipate the change in policies. Thus, expansionary fiscal measures that try to achieve more employment at the cost of some inflation – taken although the government announced not to engage in expansion beyond the »natural« level of employment since it is inflationary – end up in generating more inflation but no additional employment. This sanction, namely ending up in the worst of all possible worlds, makes policy-makers accept rules that visibly tie their hands.

At the heart of this inconsistency problem lies a discrepancy between the preferences of the representative economic actor/median voter and elected policy-makers. In comparison with the median voter, policy-makers are more impatient to see results, that is have a higher discount rate, or a different valuation of goals and typically give more weight to employment in contrast to price stability. Rules or institutions that policy-makers create in order to constrain themselves do not reflect changes of their preferences; on the contrary, the rules signal the subordinate's resolve to get better results given the very same preferences.

In this world view, the constitution of EMU had to safeguard prudent member states and the union against the spill-overs from macroeconomic discretion of sovereign governments with interventionist instincts. Prime examples of such safeguards that serve this purpose are the SGP and the European Central Bank whose constitution requires her to care above all for price stability independently of all interference from member state governments. EU members but EMU outsiders like Denmark, Sweden and the UK are covered by the general obligation to conduct policies with a view to the »common concern«. Multilateral surveillance following the rule of the Broad Economic Policy Guidelines is there to ensure the prudence of national policies for the EU as a whole. They extend to all EU member states the stipulations of the SGP, namely to maintain the budget close to balance or in surplus and to keep deficits below the three percent threshold. The only difference to EMU members and the SGP respectively is that there is no Excessive Deficit Procedure threatening to fine the fiscal authorities if they violate these stipulations.⁶

6 See Directorate General (2002) for a clear outline of the framework for economic policy coordination in the EU.

This institutionalisation of fiscal policy coordination providing for an equally negative form of coordination, namely asymmetric surveillance, seems to reveal low preferences for further political integration. Yet, this reading of causation from preferences to institutions may be spurious. It could well be a lack of incentives rather than enduring mistrust that the rules in place reveal while at the same time being unable to enforce compliance. Present arrangements give only negative incentives to play by the rules, namely avoiding blame and shame or even more tangible sanctions. An insurance arrangement to serve stabilisation with a rainy day fund or a community stabilisation mechanism would (have) lead to self-selection of members who trust each other at least that much. By contrast, the fudging of the Maastricht criteria meant that members were admitted even though they were off the steady state but then were asked to comply with rules that cater to stabilisation only in the steady state. Apparently, stabilisation now has to be confined to measures that do not allow for discretion of governments one cannot trust. Yet this interpretation may be unwarranted and non-compliance a result of internal inconsistencies in the present policy framework rather than indication of mistrust that was proven to be justified by recent breaches. The next section will explore whether the rules are consistent in combining the focus on national consolidation with an exclusive reliance on automatic stabilisation.

4. The norm and empirics of automatic stabilisation

In contrast to the insurance approach, the »fiscal philosophy« of the SGP is that policy coordination in EMU should care primarily about fiscal consolidation (»close to balance or in surplus«), while stabilisation proper should be automatic (Buti et al 2002: §1). This and balanced budget amendments in the US have revived research in the operation and effectiveness of automatic stabilisers which was virtually non-existent between the mid-1980s and the late 1990s (Cohen/Follette 2000, Fatás/Mihov 1999, van den Noord 2000). The basic finding of the ensuing empirical research is that automatic stabilisation is effective: countries with a more generous welfare state and a progressive tax system get more smoothing (European Commission 2001). An ECB study that compares its estimates with that of the OECD and the European Commission finds that budget balances as a percentage of GDP change by about 0.4 – 0.6 percent in response to a one percent change of GDP in EU countries and the EU-15 on average (Bouthevillain et al. 2001: 42).

What is novel is that this research has explored supply-side channels through which automatic stabilisers work and the related finding that their effectiveness depends on the source of the shock. To start with these novel findings on why and when automatic stabilisers seem to work: Traditional as well as New Keynesian studies identify the impact on effective or – in New Keynesian accounts – optimal demand (Bayoumi/Eichengreen 1995, Allsopp et al. 1997).⁷ The smoothing of disposable income leads to less volatile patterns

7 See Cohen/Follette (2000) for a model with optimizing consumer response that also allows to explore automatic stabilisation of supply side shocks.

of expenditure. The focus on stabilisation operating on the demand side may overstate the extent of stabilisation provided, however (Blanchard 2000: 70). Taking the supply side and the political economy of fiscal policy into account makes for more ambiguous theoretical predictions and calls for empirical settlement of the net effect. On the one hand, automatic stabilisers may have negative effects on the supply side: they allow for less or slower adjustment, thus favour more wage rigidity and less mobility. Moreover, an asymmetric use of automatic stabilisers over the business cycle, that is running deficits in a downturn but spending the endogenous surpluses in an upturn, leads to debt accumulation (van den Noord 2000, Buti et al. 2002). Rising risk premia and the sheer burden of servicing the public debt then weakens or even perverts the operation of automatic stabilisers (Fatás/Mihov 1999: tables 3 and 13). On the other hand, the very same stabilising properties may be of relevance to the long-term growth potential of the economy insofar as it is determined by the supply side: they prevent fluctuations in resource use such as underinvestment and subsequent destruction of physical and human capital; and they allow for tax and expenditure smoothing (van den Noord 2000). They may even compensate for some financial market imperfections such as individuals being more liquidity-constrained than government.

The ambiguous net effect of automatic stabilisers suggests to search for a critical size of taxation below which there is not only less distortion but properties of automatic stabilisers improve. In Buti et al. (2002), this critical value is derived theoretically by making the elasticity of the short-run Phillips trade-off endogenous. Beyond the safe level, wages become more rigid and thus the trade-off less responsive. Another line of research that takes the debt and deficit implications of automatic stabilisation as a starting point is to establish »safe« deficit targets that would allow automatic stabilisation to run its course without jeopardizing the three percent limit (Artis/Buti 2000 and 2001, Barrell et al. 2002). While Artis/Buti (2000, 2001) thus endorse a structural target of »close to balance or in surplus«, the latter conclude that in most cases a deficit of one percent would be a safe margin.

Yet, is this proposition of consolidation, that is downsizing of budget deficits to one percent or even to balance, compatible with effective stabilisation and even if, is purely automatic stabilisation sufficiently effective? Fatás/Mihov (1999) provide a thorough study of the question whether it is size of government that makes automatic stabilisation an effective tool of fiscal policy or whether, alternatively, this is spurious causation as more volatile economies tend to have larger governments. Thus, after having established that government budgets actually fulfil a stabilising function, in line with the results of other authors reported above, they ask for the direction of causation, namely whether size is endogenous (volatility brings about bigger governments) or an independent determinant or both.

Obviously, causation is a crucial question for EMU since integration makes economies more open while the SGP calls for a downsizing of the government sector. Both hypotheses imply effective stabilisation but they differ in the direction of causation: does size cause (less) volatility or does (high) volatility cause size (which subsequently reduces volatility)?

Galí (1994) has ventured that automatic stabilisers affect not only disposable income as has been traditionally claimed, explicitly or implicitly assuming the volatility of GDP to be exogenous. But the latter may be an endogenous result of stabilisation if government is large and thus has less need for stabilisation of incomes to begin with. However, what counts for this endogenous reduction of GDP volatility? Rodrik (1998) suggests that open economies which are more susceptible to exogenous shocks get bigger governments over time. Only if the government provides social protection against the instability of income and jobs can open economies sustain their openness.

The findings of Fatás/Mihov (1999) suggest that Rodrik's (1998) conjecture of reverse causation has a point – »conditional on the size of government openness increases volatility of output« (Fatás/Mihov 1999: 14) –, but it does not explain fully the direction of causation. They provide two pieces of evidence on this: First, regressing a number of alternative measures of volatility on government size in OECD countries, they get a negative relationship in each case – i.e. more volatility does not »explain« the size of the budget. Particularly telling is a significant reduction of volatility in private output:

»These results suggest that the stabilising effect on GDP of larger governments is not simply the mechanical result of having a larger and more stable government sector.« (Fatás/Mihov 1999: 12, table 6)

Secondly, intranational evidence from US states provides an even larger negative effect of government size on volatility than that for OECD countries:

»An increase of government size by one percentage point (of GDP) will reduce the volatility of output (standard deviation of GDP) by 0.07 in the OECD sample and by 0.21 in the US states sample.«

This indicates that causation runs indeed from bigger size to less volatility because federal fiscal variables are determined by the central government and because US states share common institutions, thus the US evidence allows to isolate this direct effect of government size on volatility (Fatás/Mihov 1999: 25).

This means in turn that downsizing of government sectors may impair stabilisation, independent of the openness of the respective economies. And if we take openness or other sources of vulnerability, such as asymmetric effects of a common monetary policy, into account, the need for effective automatic stabilisers and thus sizeable budgets become even more pressing. The sole focus on consolidation that is built into the SGP and the reforms proposed by Buti et al. (2003) is thus at odds with an exclusive reliance on automatic stabilisation that is maintained at the same time.⁸

8 See also Wren-Lewis (2000) and von Hagen/Mundschenk (2002) for a slightly different but succinct and informative critique of the sole reliance on automatic stabilisation.

5. *Concluding remarks*

What difference does it make to re-interpret the most prominent reform proposals in an insurance perspective? On the one hand, it gives other and arguably more plausible rationales to the proposals of non-partisan and symmetric enforcement of fiscal rules for policy coordination, as well as the targeting of structural and country-specific balances. They are endorsed as part of an insurance arrangement inasmuch as they make collective stabilisation more effective. The more general point is that while risk-sharing via policy coordination does require discipline of members, that discipline is to some extent self-enforcing if it is a means to get insurance and not an end in itself. This is the fundamental difference to the underlying philosophy of the SGP.

While of theoretical interest in line with the plea of Buti et al. (2003) to overcome the ad-hocery of present reform debates, it is not purely academic. The discussion of the role of automatic stabilisation was meant to show that, ultimately, it is not consistent to exclusively rely on automatic stabilisation and simultaneously devise policy coordination with the sole intention to bring about national fiscal consolidation. However, the focus on automatic stabilisation makes sense in a coordinated effort to maintain and enhance this function of government because it can reduce the lags of spontaneous or discretionary orchestration.

Moreover, this perspective suggests that one has to go further down the route that the Buti et al. (2003) proposals take in order to make governments engage in collectively effective stabilisation. The insurance view endorses above all proposals that argue in favour of an aggregate fiscal target. Interestingly, the Commission had itself proposed to take the aggregate into account when assessing the appropriate stance of national fiscal policies when it responded to the draft of the German Treasury in the mid-1990s (Costello 2001: 116 f.). However, this alternative Commission proposal was rejected by the Council. It is about time to re-consider this early proposal and simultaneously try the more innovative scheme of tradable permits that Casella (1999) devised at the national level, for instance in a federal state like Germany.

Another major reform is changing the nature of sanctions – a proposal that has its rationale in an insurance or risk management approach and cannot be justified by Buti et al. (2003) given their steady state perspective. If economies are typically off the steady state or can be trapped in »bad« equilibria and the goal of macroeconomic intervention is to bring them closer to or into a favourable equilibrium, then sanctions should not themselves be a source of destabilisation and uncertainty.⁹ Political sanctions would therefore be preferable, for instance suspending voting rights in the Council as long as a government does not fulfil its obligations as established by an independent body. This should be a very effective political mechanism of blame and shame, confined to the government that presumably has not done its homework, while not doing harm to the macroeconomy and

9 See Betz (2001) for a Keynesian theory of economic policy that stresses the reference to equilibria.

the material wellbeing of the electorate. Finally, what is the role for discretion and active intervention? The discussion of automatic stabilisation above suggests, somewhat ironically, that there will be a case for discretion inasmuch as governments try to downsize and thus automatic stabilisers becoming less effective. In other words, the maxim »rules rather than discretion« to enforce fiscal prudence is self-defeating. The more governments follow the call for consolidation and macroeconomic policy restraint, the less they can rely on rule-based stabilisation if they do not want to give up this crucial function of the government budget at all.

By contrast and from an insurance point of view, rule-based coordination has the obvious advantage that it delivers more security. If governments are risk-averse, security is by definition the welfare gain they derive from insurance: one Euro of transfer payments that a government can count on thanks to the rules is more valuable than one Euro that is the uncertain outcome of a bargain. This rationale of rule-based coordination does, however, not preclude all discretionary intervention nor does it call for a withering away of public debt as the maxim »close to balance or in surplus« implies for growing economies. Stabilising intervention and safe assets are welcome in a world that is notoriously off the steady state.

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